IN THE

Supreme Court of the United States

OCTOBER TERM, 1952

No. 160

MEREDITH H. METZGER, HENRY OFFERMAN and J. S. FARLEE & CO., INC.,

Petitioners,

vs.

WESTERN PACIFIC RAILROAD COMPANY, SACRAMENTO NORTHERN RAILWAY, TIDEWATER SOUTHERN RAILWAY, DEEP CREEK RAILROAD COMPANY, THE WESTERN REALTY COMPANY, THE STANDARD REALTY AND DEVELOPMENT COMPANY and DELTA FINANCE CO., LTD.,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR PETITIONERS

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ing companies,* acquired 61% of plaintiff's common and 8.8% of its preferred stock (R. 501), constituting control. By 1943 plaintiff's common stock, ranging behind more than $38,000,000 of preferred (R. 1717), had become completely worthless.

But the James Interests also held large amounts of the secured obligations of respondent (R. 1718) which, under the reorganization plan, entitled them to 28% of the to-be-issued stock of respondent (Pl. Ex. 1).** It was therefore to the advantage of the James Interests to favor respondent, not plaintiff. Thus if the tax savings here involved enured to respondent, the James interest therein was 28%; while it was only 8.8% if the tax savings went to plaintiff.

The James Interests acted in accordance with their advantage: They abandoned plaintiff and cast their lot with respondent. They decided to support respondent's reorganization plan (R. 618) which theretofore they had opposed (R. 536-7). They decided to withhold further advances to plaintiff (R. 575-6); the James representatives on plaintiff's board retired (R. 1480); and at plaintiff's annual meetings the James stock was neither represented nor voted (Pl. Ex. 19, R. 503; Def. Ex. 54, R. 1632, 2053-2069). Plaintiff was thus deprived of that measure of protection and supervision which a vigilant controlling stockholder ordinarily would exercise over a corporation's management.

Plaintiff's 4700 public stockholders (R. 659), scattered throughout the country (R. 659), were forced into equal inactivity since plaintiff was too impoverished even to

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* Arthur Curtiss James died in 1941 (R. 745). He, his estate, his personal holding companies (R. 503) and the James Foundation of New York, Inc. (R. 1011) are herein referred to as the "James Interests".

** Under the plan, the James Interests were entitled directly to 21½% of the respondent's new voting stock (R. 975) and, in addition, to convertible bonds of respondent which the James Interests subsequently converted into voting stock of respondent (R. 1718; see R. 1725-8), giving them an aggregate of 28%.

send out proxies or proxy statements for its annual meetings (Def. Ex. 54, R. 1632, 2053-2069). None of those meetings was therefore attended by a quorum (Pl. Ex. 19, R. 303).

The protection of plaintiff's interests was thus left entirely to the integrity and vigilance of its officers and directors.

(c) *Plaintiff's officers.* During the period in which the consolidated tax returns and the refund claim were filed—1944 and 1945—plaintiff had only two officers: Its president *Curry* and its secretary *Wienken*, later replaced by *Valouch* (R. 1719).

Michael J. Curry was not only the president, treasurer and a director of plaintiff throughout the critical period (R. 1719, 1720) but, at the same time, also a vice-president, a director and a member of the executive committee of *respondent* (R. 719, 1724).*

With all his titles, Curry considered himself merely a "figurehead" (R. 646-7). His actual position was, and had been since 1927, simply that of chief clerk or office manager (R. 639); he was "merely a signing officer" (R. 641, 1450) and signed whatever documents Schumacher (*respondent's* chairman) or Elsey (*respondent's* president) told him to sign (R. 642).

From June 1, 1943 Curry's entire compensation was paid by *respondent* (R. 1738); nothing whatever by plaintiff (R. 645).

After the closing of the New York office on April 30, 1945, *respondent* arranged for Curry to move to the offices of Whitman Ransom Coulson and Goetz, respondent's tax counsel (R. 1287-8), and for them to pay him a $3,000 annual "retainer", because Curry's services "as president of the old holding company" (i.e., plaintiff) were "essential"

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* Curry resigned as respondent's vice-president on April 30, 1945 (R. 1724) and as respondent's director on November 20, 1944 (R. 719).

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Opinions Below

The decision of Goodman, D.J., in the United States District Court for Northern California, Southern Division (R. 258), dismissing the action after a trial without jury, is reported 85 F. Supp. 868.

The District Court's decision was affirmed on appeal. The prevailing and dissenting opinions in the United States Court of Appeals for the Ninth Circuit, both on the appeal

itself and on petitions for rehearing (R. 2214, 2239, 2260, 2261, 2289, 2296), are reported 197 F. 2d 994.

A supplemental dissenting opinion (R. 2313) has not yet been reported.

Jurisdiction

The District Court's jurisdiction was predicated on diversity of citizenship and presence of the jurisdictional amount; 28 U. S. C., § 1332. The jurisdictional facts are alleged in the Complaint (R. 6) and admitted in the Answers (R. 12, 117-8).

The jurisdiction of the Court of Appeals rested on 28 U. S. C., § 1291.

The jurisdiction of this Court rests on 28 U. S. C., § 1254(1). The judgment of the Court of Appeals was entered October 29, 1951 (R. 2255). A timely petition for rehearing, filed December 17, 1951, was denied on January 30, 1952 (R. 2256-7, 2259-60). On April 24, 1952, by order of Mr. Justice Douglas, petitioners' time to file a petition for certiorari was extended to June 27, 1952. The petition for a writ of certiorari was filed June 26, 1952, and granted October 13, 1952.

The Parties

This action was brought by the plaintiff Western Pacific Railroad *Corporation* (hereinafter called the "plaintiff" or the "Corporation"). The defendants, respondents here, are the Western Pacific Railroad *Company* (hereinafter called "respondent" or the "Company")* and certain of its subsidiaries. The latter have comparatively minor stakes in this litigation.

* With respect to the period from November 1935 to December 1944, the reference to "respondent" or the "Company" will include its reorganization trustees in whose hands, during that time, were respondents' assets and affairs. Respondent, upon emerging from its reorganization, assumed the obligations of the trustees (Pl. Ex. 15, R. 499, 1712, 1713).

The petitioners here are preferred stockholders of plaintiff, owning 25,465 shares of plaintiff's preferred stock (R. 1650-2); about 6.7% of all of the preferred outstanding (R. 1717). Petitioners became stockholders of plaintiff between July 1942 and February 1944, long before the transactions complained of (R. 1650-2).

Petitioners were permitted to intervene in this action as parties plaintiff (R. 122). Plaintiff as well as petitioners appealed from the adverse decision of the District Court (R. 326-7); and, after the affirmance by the Court of Appeals, both were granted certiorari by this Court.

In the light of the able and learned brief submitted by counsel for plaintiff, we would hesitate to burden this Court with an additional memorandum were it not for certain differences in presentation and analysis which we consider as important. The differences arise from the history of the litigation and the peculiar position of these petitioners.

In June, 1946—prior to this action—the petitioners instituted a stockholders' action in the federal District Court for Southern New York, in which the claim involved herein (in addition to other claims) was asserted for the first time (R. 337, 706-7, 1024). The New York complaint alleged, in short, that plaintiff and respondent had interlocking managements; that plaintiff was controlled by respondent's agents; that these facts created a fiduciary relation between plaintiff and respondent, requiring respondent to deal fairly with plaintiff; and that respondent, in certain tax transactions with plaintiff, had breached its fiduciary duty to plaintiff by appropriating all benefits of the transactions to itself and allowing none to plaintiff.

After the legal sufficiency of the New York complaint had been sustained (R. 337), plaintiff's management and attorneys (named as defendants in New York) caused the Corporation to bring the present action on October 10, 1946, complaining of the same tax transactions with respondent (R. 5).

Plaintiff, however, failed to allege the managerial interlock between the parties or the control of plaintiff by respondent's agents. Accordingly, we moved for leave to intervene herein on the ground that plaintiff's management inadequately represented the rights of plaintiff and its stockholders; and this motion was granted on April 7, 1947 (R. 122).

Our intervenors' complaint (R. 123) alleged the facts, omitted by plaintiff, establishing what we conceive to be the all-important fiduciary relation between plaintiff and respondent. Plaintiff at first denied these allegations and put us to our proof * (R. 156); later on plaintiff adopted certain of our allegations, but not those referring to its own personnel (R. 208); until finally plaintiff's present counsel, retained on the eve of trial, likewise proclaimed the existence of the fiduciary relation.

Nonetheless, substantial differences still exist between plaintiff and petitioners in the presentation and analysis of the factual basis and the legal effect of this fiduciary relation. As intervenors, we are not bound by any admissions of plaintiff, *Park & Tilford v. Schulte,* 160 F. 2d 984, 988-9 (C. C. A. 2, 1947), cert. den. 332 U. S. 761. We are therefore impelled to submit this separate brief in which, appearing on behalf of stockholders (not management), we can let the chips fall where they will.

Statement of Case

1. Plaintiff's $75,000,000 stock loss.

In 1916 plaintiff, a holding company, acquired all the stock of respondent, an operating railroad company (R. 493). Plaintiff's investment in respondent's stock was more than $75,000,000 (R. 262).

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* The petitioners accepted this invitation, as demonstrated by the extensive depositions (R. 275) which produced the evidence at the trial.

In 1935 respondent went into bankruptcy reorganization (Bankruptcy Act, § 77) in the District Court for Northern California, Southern Division. Its property was placed in the hands of two court-appointed trustees (R. 494). In 1939 the Interstate Commerce Commission promulgated a plan of reorganization (233 I. C. C. 409) which declared that respondent's stock held by plaintiff was worthless and not entitled to share in the assets of the reorganized Company (R. 259, 495). Under the plan the secured creditors of respondent were to become its new owners and were to receive all of its stock, when issued.

This reorganization plan was approved by the District Court in 1940 (R. 259). Although reversed on appeal, *In re Western Pac. R. Co.*, 124 F. 2d 136 (C. C. A. 9, 1941), the plan was, on March 15, 1943, reinstated and affirmed by this Court and thus became final; *Ecker* v. *Western Pac. R. Corp.*, 318 U. S. 448 (1943). In due course, the plan was confirmed on October 11, 1943 (R. 260); and it was consummated on December 29, 1944 when the reorganization trustees returned the assets to respondent and respondent issued its new securities in accordance with the plan (R. 499, 2000).

The results of respondent's reorganization were shattering to plaintiff. Its principal asset, the $75,000,000 investment in respondent's stock, was totally lost. The loss was irretrievable; for however prosperous respondent might become in the future, plaintiff had no part therein. From March 15, 1943—the date of this Court's affirmance of the reorganization plan—the economic unity between plaintiff and respondent was severed; plaintiff and respondent became and remained complete strangers to each other.

2. Plaintiff's tax credit and its use to save respondent's taxes.

Staggering as plaintiff's loss was, it presented one mitigating feature: The amount of the loss could be used as an income and excess profits tax deduction. The right to this tax credit was created by Internal Revenue Code,

§ 23(g)(4),* enacted in 1942 (56 Stat. 820), which provided that losses resulting from the worthlessness of the stock of an affiliate are to be treated as operating losses (rather than as capital losses as theretofore).

But plaintiff was not allowed to derive any benefit from this tax credit. Instead, the entire benefit was reaped by respondent. This was accomplished through the mechanics of consolidated tax returns.

(a) Consolidated tax returns may be filed by an affiliated group of corporations headed by a common parent and inter-connected by at least 95% stock ownership (Internal Revenue Code, § 141). In such a consolidated return the affiliated group is treated, for tax purposes, as a single enterprise, so that the losses sustained by any one or more affiliates are deducted from the profits realized by the other affiliates. Only if the group as a whole realizes a net profit is a tax payable thereon.

A consolidated return can be filed only by the parent corporation of the group; and it requires the consent of all affiliates. Treas. Reg. 104, § 23.12(b) and § 23.16(a), 26 C. F. R. (1949), § 23.12(b) and § 23.16(a).

(b) Plaintiff, as stated, owned all of respondent's stock. Although this Court's decision of March 15, 1943, had rendered the stock economically worthless, the stock was still legally valid because respondent's reorganization was not yet consummated. Plaintiff continued to own the stock until April 30, 1944, on which date plaintiff surrendered it to respondent's reorganization committee (R. 260). This legal stock ownership made it possible for plaintiff to file consolidated tax returns for itself and respondent, covering the year 1943 and the first four months of 1944 (see *infra*, pp. 57-58).

During this period respondent had realized very substantial profits from its war-time railroad operations. Ordi-

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* The text of the statutes and regulations cited is set forth in the Appendix of this brief.

narily respondent would have had to pay a huge tax—more than $17,000,000—on its profits (R. 262). But there was an alternative to the payment of this tax: If plaintiff filed consolidated tax returns, plaintiff's tax credit arising from its stock loss could be offset against respondent's profits, and no tax would be payable. This possibility of offsetting plaintiff's loss against respondent's profits existed not only in the year 1943, in which plaintiff's stock loss had occurred; but plaintiff's tax credit could also be "carried back" to 1942 and "carried forward" to 1944 (Internal Revenue Code, § 122(b)).

(c) The opportunities offered by the tax laws were utilized. Under circumstances to be detailed below, respondent caused plaintiff to file consolidated returns for 1943 and the first four months of 1944.* These returns (Pl. Exs. 4-A, 4-B, 5-A, 5-B) claimed plaintiff's stock loss as a complete offset to respondent's earnings; hence they reported no tax as due; and respondent paid no taxes for these periods (R. 266-7).

Nor was this all. Respondent had paid $4,201,821.54 in taxes for 1942 (Pl. Ex. 6; R. 492, 1654-6). But the carry-back of plaintiff's stock loss to 1942 would eliminate all of respondent's tax liability for that year. Accordingly, plaintiff filed a claim with the Government for the refund of these $4,201,821.54 (Pl. Ex. 6; R. 492, 1654).

These documents—the consolidated returns and the refund claim—were each filed after March 15, 1943, the date of the economic severance of plaintiff and respondent, namely:

> the 1943 returns on July 15, 1944;
> the 1942 refund claim on March 9, 1945;
> the 1944 returns on June 15, 1945.
>
> (Pl. Exs. 4-A, 4-B, 5-A, 5-B, 6; R. 491-2.)

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* For brevity, the returns for the first four months of 1944 are hereinafter referred to as the "1944 returns".

(d) The Government did at first dispute the propriety of deducting plaintiff's stock loss, principally on the ground that the loss had occurred in 1940 and was therefore inadmissible as a deduction against 1943 income (R. 267, 1423-8). Finally, however, in August 1947, the Government consented to a settlement; plaintiff agreed to the rejection of its refund claim for 1942, while the Government acquiesced in the 1943 and 1944 tax returns showing no tax due (R. 171-5, 262-3).

The District Court found that, but for the use of consolidated returns and the deduction of plaintiff's stock loss, respondent would have had to pay more than $21,000,000 in taxes for the period 1942 to 1944 (R. 261-2, 265). As a result of the settlement, respondent paid only about $4,000,000, so that it realized a net tax saving of more than $17,000,000 (R. 266-7).

All of these savings were retained by respondent. Plaintiff has obtained none.

3. The anomalous nature of respondent's retention of the tax saving and the denial of any tax benefit to plaintiff.

(a) Normally the tax credit arising from a stock loss—such as that sustained by plaintiff—redounds to the benefit of the party who suffered the loss. This is as it should be, since the tax deduction is designed to mitigate the loss.

Normally, this reasonable result obtains also where a parent corporation, by filing consolidated returns, deducts its loss from the earnings of a subsidiary. For the tax saving of the subsidiary redounds automatically—through the payment of dividends or through the increased value of the parent's equity in the subsidiary—to the benefit of the parent which, in an economic sense, owns the assets of the subsidiary. Again this accords with the purpose of the tax law which permits consolidated returns in order to give the parent, as the owner of the group, the benefit of all group losses, both its own and its subsidiaries'.

But this normal and intended result of the operation of the tax laws (more fully discussed *infra*, pp. 50 et seq.) completely failed in the case at bar. At the time the consolidated returns here were filed, plaintiff's stockholdings in respondent had been declared worthless by this Court; the economic relationship between plaintiff and respondent had been severed; and plaintiff derived no benefit whatever from any tax savings flowing to respondent. The purpose of the tax laws was thus perverted: The prosperous respondent obtained a wholly gratuitous deduction for a loss which it had never suffered; while the intended automatic upstream flow of respondent's tax saving to its parent, the plaintiff, was prevented by the economic severance of the parties. Plaintiff's stock loss remained unalleviated by any tax advantage; while respondent obtained an undeserved and unmotivated tax windfall.

(b) Plaintiff nevertheless had the means to cause the tax benefits to go where, in justice and by the spirit of the tax law, they belonged, namely, to plaintiff. For plaintiff had, as a matter of law, a free choice whether or not it would file consolidated returns (R. 1458).* Before filing consolidated returns plaintiff's management could have made suitable arrangements with respondent concerning the ultimate disposition of the resulting tax savings—a type of arrangement both legal and by no means unusual (*infra*, pp. 72 et seq.). If respondent was willing to do equity it was bound to agree that the tax benefits flowing from plaintiff's $75,000,000 loss should belong to plaintiff in order to mitigate that loss. If respondent insisted on its pound of flesh, plaintiff could at least have made sure that it would

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* Under Internal Revenue Code, § 141 (a), the filing of consolidated returns is a "privilege" the exercise of which is optional. The fact that plaintiff had filed consolidated returns in earlier years, did not prevent it from filing separate returns for 1943 and 1944; 2 *Montgomery's Federal Taxes, Corporations and Partnerships* (1946-47), 649-650.

receive an appropriate portion of the tax savings. Under no circumstances was respondent in a position to demand that all the tax savings be given to it and that plaintiff get nothing.

And yet this is precisely what was done. Although virtually all of the tax savings were, by the intent of the tax law and by every instinct of reason and equity, intended to mitigate plaintiff's loss; and although none of the savings could have been accomplished without plaintiff's filing consolidated returns and the use of plaintiff's tax credit; nevertheless plaintiff was not allowed to receive one cent. Respondent was permitted to retain for itself the entire $17,000,000.

4. Duality of Management.

This complete and abject surrender of plaintiff's interest to respondent has a simple explanation: The allegiance of plaintiff's management to respondent. In short, during the critical period in which the consolidated returns were filed, plaintiff's officers were actually subordinate employees of respondent; a majority of plaintiff's board of directors were employees of respondent; plaintiff's lawyers were simultaneously lawyers for respondent. All compensation paid to these persons was paid solely by respondent, not one cent by plaintiff. These were the people who were charged with the responsibility of protecting plaintiff's interests in its relation to respondent.

The duality of allegiance of plaintiff's management forms an important basis of our claim; it created the fiduciary relation and respondent's duty to deal fairly with plaintiff. The facts must therefore be stated in somewhat more detail.

(a) *Plaintiff's financial collapse and its dependence on respondent.* This Court's affirmance of respondent's reorganization plan on March 15, 1943 left plaintiff as an

empty corporate shell. Its assets were pledged with creditors; it had no income; it had no funds (Pl. Ex. 47; R. 570, 573, 789-790). Its principal investment, the stock of respondent, was declared worthless. At the same time, its only other substantial asset, a one-half interest in the stock of the Denver Railroad, was eliminated by the latter's reorganization plan (R. 575).* As one of plaintiff's directors put it, plaintiff had become a "corporation without assets", a mere "non-entity" (R. 1130-1).

From the early days of their affiliation, plaintiff and respondent had maintained a joint office in New York, staffed by common employees (R. 643). On June 1, 1943, on the heels of this Court's decision, respondent assumed the whole expense of the New York office and took over plaintiff's officers as "full time employees" of respondent (Pl. Ex. 30, R. 527, 1738). The individuals thus taken over by respondent nevertheless remained the officers of plaintiff, but received their compensation solely from respondent, nothing from plaintiff (Pl. Ex. 23, R. 520, 1721; Pl. Ex. 27, R. 523, 1729-33). On April 30, 1945, at respondent's direction, the New York office was closed (R. 650) and plaintiff's officers and records were quartered at the offices of Whitman Ransom Coulson and Goetz, respondent's New York tax counsel (R. 651-2, 655).

Plaintiff's financial collapse, as will be seen, had its inevitable effect upon plaintiff's officers, directors and lawyers. Even plaintiff's dominant stockholder, finding its economic stake in respondent much larger than that in plaintiff, switched its allegiance to respondent.

(b) *Plaintiff's stockholders (the James Interests).* In 1925, one Arthur Curtiss James, through his personal hold-

* The Denver's reorganization plan, approved by the I. C. C.'s order of June 14, 1943 (254 I. C. C. 349, 385), was subsequently affirmed by this Court, *Reconstruction Finance Corp. v. Denver and R. G. W. R. Co.*, 328 U. S. 495 (1946).

"in connection with the pending tax questions which your company [i.e., respondent] has up with the Federal Government" (Pl. Ex. 32-A, R. 528, 1744). Respondent agreed to reimburse Whitman Ransom for these retainer payments "as one of our disbursements in connection with the pending tax matters" (R. 1746, 1288). Thus *respondent* paid Curry in order that, as *plaintiff's* president, he might help *respondent* in its tax matters. Respondent also paid Curry a small pension (R. 653). Curry remained with the Whitman Ransom firm until the latter part of 1948 (R. 656).

During the time when Curry should have safeguarded plaintiff's interest against encroachments by respondent, he was thus an officer and director of respondent and his livelihood depended on respondent.

John F. Wienken was plaintiff's only other officer, to wit, its secretary; and he remained such until May 1, 1945 (R. 1719). He was also a director of plaintiff until April 25, 1946 (R. 1720). Although adorned with these weighty titles, Wienken was actually a stenographer (R. 648) employed by both plaintiff and respondent in the joint New York office. Since June 1, 1943, his $2,875 annual salary was paid solely by *respondent* (R. 1735, 1738).

Mary C. Valouch became the secretary and a director of plaintiff on May 1, 1945, upon Wienken's resignation and the closing of the New York office (R. 1719, 1720). For many years before that date, Valouch had been a clerk in the employ of *respondent* (R. 530); she handled the Western Pacific tax matters and did secretarial work (R. 647). Since June 1, 1943 she received her salary—less than $3,000 annually—solely from *respondent* (R. 1735, 1738). Upon the closing of the New York office and her appointment as secretary and a director of plaintiff, she moved—together with Curry—to the Whitman Ransom firm and became its employee (R. 530, 652).

Each of the three officers of plaintiff—Curry as president, and Wienken, succeeded by Valouch, as Secretary—was thus during the critical period in the employ and pay

of respondent and subject to the inevitable tug of loyalty to his paymaster. By the very nature of their employment they were nothing but dummies and figureheads.

(d) *Plaintiff's directors.* Nine persons were, during all or part of the critical period from 1944 to 1945, directors of plaintiff: Curry, Wienken, Valouch (from May 1, 1945), Schumacher, Sheehan (from February 15, 1944), Hatton, Osborn, Wood and Campbell (until May 1, 1945) (Pl. Ex. 22, R. 1720).

Three of these—Curry, Wienken and Valouch—have been discussed and their financial dependence on respondent shown.

Thomas M. Schumacher was the real "boss" of the New York office before and during the critical period (R. 639, 736). Since 1927 he had been the chief executive officer and a director of both plaintiff and respondent (R. 735); and in 1935 the bankruptcy court appointed him as one of the two reorganization trustees of *respondent* (R. 735). On February 1, 1942—before the critical period of the consolidated returns here involved—Schumacher resigned as plaintiff's president because of plaintiff's inability to pay his $15,000 salary (R. 743). Nevertheless, in his capacity as trustee for *respondent* (R. 738-9), Schumacher continued "in command of the New York office" (R. 736) until December 31, 1944, when respondent emerged from the reorganization and Schumacher retired (R. 1724) with a $12,000 pension from *respondent* (Pl. Ex. 34-C, R. 532). Although no longer an officer of plaintiff, Schumacher continued as a member of its board of directors until his death in early 1948. Throughout the critical period Schumacher was paid only by *respondent*, not by plaintiff (R. 645).

Catherine Sheehan was the telephone operator, receptionist and filing clerk in the joint New York office (R. 647, 1138). Her $2,000 salary was paid solely by *respondent* (R. 1138-9, 1738). She was elected to plaintiff's board

in order to fill a quorum (R. 1139), never took part in the discussions of the board and, in casting her vote, simply followed the majority (R. 1140).

William W. Hatton was a minor officer of the Denver Railroad (R. 1134), charged with "purely clerical" duties at a salary of $4,500 (R. 1137). Schumacher, bankruptcy trustee of *respondent*, was his "superior and chief" (R. 1135). Hatton—like Sheehan—was elected to plaintiff's board in order to fill a quorum (R. 1137-8); he never participated in board discussions and simply voted with the majority (R. 1136).

A. Perry Osborn was not only a director of plaintiff since 1937 (R. 988), but also a director and member of the executive committee of *respondent* to November 20, 1944 (R. 992).

Willis D. Wood was a long time friend of Arthur Curtiss James, at whose request he had joined plaintiff's board (R. 1123). During the period 1943-45, Wood and his family owned substantial amounts of *respondent's* securities (Int. Ex. 11, R. 2138-2141), but none of plaintiff's, except qualifying shares (Pl. Ex. 17, R. 501, 1717). Since this Court's decision of March 15, 1943, he considered plaintiff a "nonentity", so that "there was no action necessary on my part, and hence I did not give it the attention that I did in former years" (R. 1130-1).

H. Brua Campbell, an attorney, was a partner of the New York law firm of Pierce & Greer (R. 532-3), who, as will presently be stated more fully, were attorneys for both plaintiff and respondent during the critical period 1944 and 1945, but received their compensation solely from *respondent,* nothing from plaintiff.

A clear majority of plaintiff's directors—Curry, Wienken, Valouch, Schumacher, Sheehan, Osborn and Campbell—thus owed their allegiance to respondent. All of those just named (except Osborn) received their pay solely from respondent, nothing from plaintiff. And even the two remaining directors (Wood and Hatton) were likewise by interest and allegiance oriented to respondent.

(e) *Plaintiff's lawyers.* Two New York law firms acted for plaintiff during the critical period *: Its general counsel, Pierce & Greer; and the firm of Whitman Ransom Coulson and Goetz, as tax lawyers.

Pierce & Greer. This firm, composed of *H. Brua Campbell* and *Frank C. Nicodemus* (R. 532-3), acted not only as general counsel for plaintiff (R. 533), but simultaneously as attorneys for *respondent* and its trustees (R. 533-6, 793). Their representation of respondent continued throughout 1945 (R. 1119-21, 2150). Since June 1, 1943 they received no compensation from plaintiff (R. 1723). They did receive an annual retainer from *respondent's* trustees and additional fees from *respondent* (R. 534-8, 1730-1, 1738).

Respondent and its bankruptcy trustees never made any bones about their conception of the duties of the Pierce & Greer firm in tax matters: They looked to the firm "to cooperate with Mr. Matthew, general counsel for the Trustees [of *respondent*], in protecting the trust estate [i.e., *respondent*] in the preparation of the final return" (Pl. Ex. 39-A, R. 543-4).

Much later, on October 10, 1946 (simultaneously with the commencement of this action), Nicodemus became a director of plaintiff.

Whitman Ransom Coulson and Goetz. In March 1943 this firm was retained, by the trustees for *respondent*, as tax counsel for the Western Pacific group, including both plaintiff and respondent (Pl. Exs. 39-A to 39-F, R. 543-548; R. 556). The firm continued as tax counsel for plaintiff until at least 1947 (R. 1438-41); and they still are tax counsel for respondent (R. 1438).

The partners in charge of the tax work were *Robert E. Coulson* and *James K. Polk* (R. 1399). Coulson was, since

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* A California attorney, Judge Marcus C. Sloss, was retained by plaintiff in 1934 solely to represent its interests as a stockholder and unsecured creditor in the reorganization proceedings of respondent, by opposing the I. C. C.'s plan of reorganization (R. 1603, 1611). He had nothing to do with plaintiff's taxes (R. 1603-4).

October 1943, a member of *respondent's* Reorganization Committee (Pl. Ex. 10, R. 496, 1674, 1675-6) and since December 28, 1944, a member of *respondent's* board of directors (R. 548).

The firm's compensation for its tax work was paid exclusively by *respondent* (R. 548-557); nothing was paid by plaintiff (R. 1721). But the firm was tied to respondent by even more profound considerations.

For nearly twenty years the firm had been personal counsel to Arthur Curtiss James and general counsel to the various corporations created by him (R. 536, 962); Coulson was an officer and director of these corporations (R. 964). As attorney for the A. C. James Company, Coulson took an active part in all steps of respondent's reorganization (R. 963). By reason of their large financial stake in defendant, the James Interests, represented by Coulson's firm, were vitally interested in *respondent's* welfare, including its taxes (R. 965); while, since the Supreme Court's decision of March 15, 1943, their interest in plaintiff was negligible; so that, as we have shown, the James Interests cast their lot with respondent and abandoned plaintiff (*supra*, pp. 11-12).

It is therefore understandable—although hardly excusable—that Polk, while attorney for both plaintiff and respondent, thought "my responsibility was to them [respondent] and not to the corporation [plaintiff]" (R. 1431).

This distorted view of a lawyer's duty to his client accorded with Coulson's ante-litem expression that his firm was dealing with the tax matters "in behalf of The Western Pacific Railroad Company [i.e., respondent]" (R. 529) and that plaintiff was "without financial stake" in the consolidated returns (R. 1744). Indeed, even after this action and the New York stockholders' suit had notified Coulson of plaintiff's "financial stake", he persisted in taking sides with one client, respondent, against the other client, plaintiff. For on December 11, 1946—while he and his firm were still actively representing plaintiff in the tax matter (R. 1438-41)—Coulson assured counsel for respondent that

his interest was "solely in protecting the operating company" [i.e., respondent] in connection with this and the New York litigation (Int. Ex. 9, R. 717, 2133-4).

To summarize: Plaintiff's entire personnel—its principal stockholders, its officers, its directors and its lawyers—was infected with dual allegiance which was bound to prompt them, in any conflict of interest between plaintiff and respondent, to give their first and foremost loyalty to respondent. We proceed to show how the conduct of these persons in handling the tax transactions was actually influenced by their divided loyalties.

5. Duality in action in the handling of the consolidated returns.

The handling of plaintiff's tax matters for 1943 and 1944 confronted plaintiff with a number of grave questions: Should plaintiff make the tax credit arising from its stock loss available to respondent by filing consolidated returns? Would plaintiff derive any benefit from so doing? If not, was plaintiff entitled in fairness to any such benefits? Should plaintiff secure a fair share of the tax savings by insisting on an agreement with respondent giving it a fair share?

Important as these questions were, plaintiff was not permitted to pose, let alone to answer them. Without so much as asking plaintiff, *respondent* made the decision that plaintiff was to file consolidated returns and make its tax credit available to respondent (R. 1448-1450, 1278). Plaintiff's role was confined to the mechanical, unquestioning and uninformed execution of respondent's decisions.

(a) *The returns for 1943.* The thought of utilizing plaintiff's stock loss as a tax deduction in consolidated returns was first suggested in Polk's letter of May 20, 1943, addressed to Curry as vice-president of *respondent* (Pl. Ex. 50, R. 591, 1757, 1760-1). The letter did not mention that plaintiff might have to be consulted.

By December 1943, Coulson and Polk were prepared to recommend definitely the adoption of Polk's suggestion (R.

1409-10). They made their recommendation—but only to *respondent*. Early in January, 1944, Polk traveled to the west coast where respondent's principal office was located, and there advised the trustees and officers of *respondent* that the use of plaintiff's stock loss in a consolidated return would eliminate all 1943 taxes (R. 1267-8, 1410-11, 1448).

Respondent, although quite unconcerned about plaintiff's concurrence in the plan, was concerned about the legal soundness of Polk's advice and therefore requested a formal opinion of the Whitman Ransom firm (R. 1268, 1411). On January 11, 1944 Coulson sent this opinion from New York to *respondent* (Pl. Ex. 54, R. 605)—with not even a copy to plaintiff (R. 665). The opinion assumed, as a matter of course, that plaintiff would join in consolidated returns and would bestow upon respondent the tax benefits flowing from plaintiff's stock loss.

Respondent was satisfied with this opinion. Without bothering to ask for plaintiff's permission, respondent simply decided * to use plaintiff's tax credit to eliminate its own taxes (R. 1448). Respondent at once acted pursuant to this decision. It reversed, in January, 1944, tax accruals of about $7,500,000 theretofore placed on its books for 1943 (R. 873, 1770). In March 1944 it advised the bankruptcy court that no taxes would be payable for 1943 (Pl. Ex. 58, R. 619, 1772). And in May, 1944—still before the 1943 returns were filed—respondent stated in its report to stockholders that plaintiff "can and will" file consolidated returns in which plaintiff's stock loss "will result in elimination" of respondent's tax liability (Pl. Ex. 20-B, R. 512).

Who, then, decided on behalf of plaintiff that it "will" file such consolidated returns? Its board of directors did not; the 1943 tax matters were never presented to plaintiff's board, either for discussion or decision (R. 1018). Nor did its then two officers, its president Curry, and its secretary Wienken. The latter had nothing at all to do

* Respondent's decision (R. 1448) was made by Elsey, its president (R. 1251), and by DeGraff, its general auditor (R. 1408).

with taxes; and Curry was a mere "figurehead", a "signing officer", and completely ignorant of tax matters ("tax matters were wholly Greek to me. I didn't understand them at all * * *", R. 808).*

The method by which respondent caused plaintiff to file the consolidated returns for 1943 was simple. After *respondent* had resolved that plaintiff would file the consolidated returns utilizing its stock loss (R. 1448, 1278), such returns were prepared by Valouch (then a full time employee of *respondent,* but neither an officer or director of plaintiff), with the help of an accountant recommended by Polk (R. 1402), and under the supervision and consultation of Polk (R. 662-3). The completed returns were given by Valouch to Curry for his signature (R. 664). At Curry's question Valouch assured him that Polk had approved the returns (R. 664). Thereupon Curry, without questioning Polk or his firm as to why plaintiff should endow respondent with the stupendous gift of this tax saving; without his asking or even thinking whether it would not be fair for plaintiff to receive the tax savings or at least a part thereof, as an offset against its huge loss; without giving any thought to the wisdom of retaining independent counsel to ascertain and protect plaintiff's rights against respondent; and without bothering to consult plaintiff's directors—Mr. Curry, the "signing officer", did just that: He signed (R. 664).

(b) *The returns for 1944.* The story for the 1944 returns is much the same as for the preceding year. Plaintiff's board was not consulted; it never considered or decided on the filing of consolidated returns (R. 1018). What happened was that on December 20, 1944 Coulson advised *respondent*—but not plaintiff—by telegram that "the only course open is to proceed as indicated in conversations

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* Curry "supervised" the preparation of the returns (R. 830) only in the sense that he was the "office manager" (R. 639) and instructed the employees of the New York office as to their duties (R. 649). He never prepared a tax return (R. 659), tax matters being handled by Valouch (R. 659; Pl. Ex. 29, R. 527, 1737).

with you, including report on the consolidated basis up to May 1 [1944]" (Pl. Ex. 62, R. 623). Thereupon the decision to file consolidated returns for the first four months of 1944 was made by *respondent*—not by plaintiff (R. 1449-50). The returns were then prepared in Polk's office and brought to Curry for his signature (R. 666). At that time Curry had moved to the Whitman Ransom suite with instructions from Coulson to "put himself at Polk's disposal" (R. 1498); and this meant that, under his retainer, he, as plaintiff's president, was to perform such services as respondent would require to achieve and safeguard the tax savings for itself. Hence when Curry was told that Polk wanted him to sign the returns, he obliged—again without asking plaintiff's board of directors (R. 666).

(c) *The refund claim for 1942* was prepared with even less ceremony than the tax returns. Polk himself decided that plaintiff should file such a claim (R. 1450). He prepared the claim; placed it before "the proper signing officer", i.e., Curry, with the request for his signature (R. 1450); and Curry signed, again, of course, without benefit of consultation or approval by plaintiff's board of directors (R. 666-7).

(d) *Curry's preoccupation with respondent's interests.* That Curry, in signing, was preoccupied with respondent's interests, not plaintiff's, is indisputably established by his own contemporaneous statements. Plaintiff was confronted in February, 1945, with a possible forfeiture of its charter for non-payment of Delaware franchise taxes. Curry, in discussing the problem, gave serious consideration to it—but only with an eye to respondent's tax savings and their possible jeopardy; and without any thought to the interests of plaintiff and its stockholders. This is clearly stated in a letter from Curry, as plaintiff's president, to Nicodemus, copy to Polk (Int. Ex. 5, R. 705, 2125-7):

> "If we default and our charter is voided, the question arises what would be the effect on the consolidated income and excess-profits tax returns filed by the Cor-

poration, as parent, for the years 1942, 1943 and 1944. As you know, a very large deduction was taken in 1943, which wiped out any tax liability for that year and will also have an effect upon the 1942 and 1944 consolidated returns. I understand the total tax saving to The Western Pacific Railroad Company [i.e., respondent] will amount to about 15 million dollars. Therefore, I feel the payment or non-payment of these franchise taxes must be determined particularly from the Federal income tax angle.

"I would suggest that before arriving at a decision in this matter you confer with the firm of Whitman, Ransom, Coulson & Goetz, our tax counsel, who are aware of this situation and are considering the consequences which the non-payment of these franchise taxes would have from an income tax viewpoint."

The same thought had long before been expressed by Coulson and Polk.* Coulson therefore decided that plaintiff's franchise tax must be paid; and the A. C. James Company—departing in this instance from its policy of making no further advances to plaintiff (R. 575-6)—loaned plaintiff the funds to pay its franchise tax (R. 713).

(e) *The tax settlement with the Government.* The proceedings culminating in the 1947 settlement of the tax dispute with the Government further illustrate the extent to which respondent managed plaintiff's tax affairs with complete disregard of plaintiff.

In 1945 and the early part of 1946, an Internal Revenue agent audited the tax returns for 1942-1944 (R. 1419). For his discussions with the Government Polk needed a power of attorney from plaintiff (R. 1424). Polk drafted

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* On May 26, 1943, Polk advised Nicodemus that plaintiff's "dissolution should be deferred * * * as tax aspects warranted" (Pl. Ex. 52, R. 601). On June 26, 1943, Coulson asked Polk whether "it would be embarrassing in the Western Pacific situation" if plaintiff's charter were cancelled for failure to pay its Delaware franchise tax; Polk replied "it is essential, to protect the possible use of the net loss carry-back, that the holding company [i.e., plaintiff] continue until the consummation of the reorganization" (Pl. Ex. 51, R. 592, 600).

such an instrument (Pl. Ex. 65, R. 626, 1784). Among other things it authorized Polk and two of his partners to "execute closing agreements", i.e., to settle any tax dispute. At Polk's request, Curry, then lodged in Coulson's office, signed this power of attorney—again, of course, without consulting plaintiff's board and without the board's knowledge or approval (R. 667-8, 1025-6). Significantly, Curry felt that the signing of the power of attorney was one of his duties under his retainer agreement with the Whitman Ransom firm (R. 906) under which the latter paid him $3,000 annually, for the account of respondent.

Armed with this power of attorney, Polk entered upon his discussions with the Government (R. 1424-5). At a conference in Washington on February 11, 1947 Polk suggested the possibility of a settlement (R. 1427-8). When the Government representative asked Polk to put his offer in writing, Polk replied that he would get authorization to do so (R. 1427). Polk promptly proceeded to procure such authorization—but only from *respondent*, not from plaintiff (R. 1429-31). He immediately telephoned Coulson, who at the time was in San Francisco, and outlined to him the proposed offer (R. 1429-30). Coulson at once consulted *respondent's* president Elsey, who, in turn, canvassed *respondent's* directors (R. 1282-4). After a few hours Elsey advised Polk by telephone that his proposed settlement offer was approved by *respondent* (R. 1430). Polk at once reduced his offer to writing and, in *plaintiff's* name, submitted it to the Government (R. 171, 1430). The thought that plaintiff might have to be consulted occurred, they say, to no one (R. 1431). Until two months later plaintiff's directors and officers had no information whatever of what was being done in their names (R. 668-9).

This patent disregard of plaintiff's rights was also manifested in the terms of Polk's settlement offer. At the time the offer was made (February 11, 1947), the present action was already pending and respondent had filed its Answer asserting certain technical defenses, such as the statute of limitations (R. 28-29). But these technical de-

fenses would obviously have been unavailable as to any moneys which might come directly into plaintiff's possession and as to which, therefore, plaintiff would not have to sue respondent. The 1942 tax savings were of that character. The refund claim for 1942 (R. 1654) was, and had to be, filed by plaintiff; if the claim had been allowed by the Government, the \$4,201,821.54 taxes for 1942 would have been paid by the Government to plaintiff.* The refund claim was therefore particularly valuable to plaintiff since the 1942 tax moneys, if collected by plaintiff from the Government, were not subject to respondent's technical defenses. Polk's settlement proposal provided that plaintiff was to surrender its refund claim for 1942, whereas respondent was to be freed of any tax liability for 1943 and the first four months of 1944 (R. 171-3). The proposed settlement was thus to be accomplished wholly at plaintiff's expense.

Not until two months later, after a conference with respondent on April 2, 1947, did it occur to Polk to notify plaintiff of the settlement offer which he had made in its name, and to request the approval of plaintiff's board (Pl. Ex. 68, R. 669, 1788, 1460-1). The board members, alerted by our New York shareholders' action to their possible personal liability, appointed a three-man committee to consider the settlement offer. On May 5, 1947 Curry, on behalf of the Committee, notified Polk that they were "prepared to recommend" to plaintiff's board the sending to Polk of a "letter of general approval", but demanded a stipulation by respondent which would assure to plaintiff its day in court, free of the technical defenses asserted in respondent's Answer (Pl. Ex. 69, R. 676, 1794). In effect, this letter instructed Polk not to proceed with the settlement until such a stipulation between plaintiff and respondent were made.

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* Treas. Reg. 104, § 23.16(a), 26 C.F.R. (1949), §23.16(a), provides that, with respect to consolidated returns, the Government deals only with the parent corporation of an affiliated group, and that refunds will be made directly to the parent.

These instructions from his client and principal made no impression on Polk. Without waiting for the stipulation or for plaintiff's "letter of general approval", without, indeeed, further asking or even notifying plaintiff (R. 681, 1027-8), Polk, on May 19, 1947, again acting as plaintiff's attorney in fact, renewed his settlement offer to the Government in the identical terms of his previous offer (Pl. Ex. 71; R. 679, 1799). On August 13, 1947 the Government accepted Polk's offer (R. 174, 1437).* In this fashion the settlement thus became an accomplished fact.

(f) *Respondent's $10,100,000 reserve for this litigation.* At the time the consolidated returns herein were filed in 1944 and 1945, respondent anticipated a tax controversy with the Government and therefore created a $10,100,000 tax reserve, which it invested in United States Treasury Savings Notes (R. 616-7).

After the tax settlement with the Government in 1947, respondent continued this $10,100,000 tax reserve as a reserve against the outcome of this litigation (R. 517-8, 617).

The Decision of the District Court.

The District Court's decision (R. 258) found that the duality of control, contended for by us, was sustained "by a preponderance of the evidence" (R. 272). It nevertheless dismissed the action upon two grounds:

In the first place, the District Court thought that the Government should not have permitted respondent to "escape" the payment of its taxes through the use of plaintiff's tax credit. The 1947 tax settlement improperly deprived the Government of taxes due to it. Equity should not compound this injustice by distributing respondent's illegal gains to plaintiff; "as between the parties, no per-

* Respondent tendered evidence that, on August 13, 1947, plaintiff's board resolved not to withdraw Polk's offer (R. 1644-5). The resolution was academic since on the same day the Government accepted Polk's offer. The trial court rejected the proffered evidence as irrelevant (R. 1647).

suasion of conscience or equity impels me to do otherwise than to leave the parties where they are". (R. 270-1, 276).

The Court of Appeals rejected this reasoning (R. 2227-8, fn. 12); and it is, as we shall show, indeed untenable.

As its second ground for dismissal, the District Court advanced this reasoning: The taxes "saved" by respondent were actually earnings which it did not pay to the Government. Plaintiff's demand for all or part of respondent's tax savings is therefore actually a demand for a share in respondent's earnings. Plaintiff cannot make such a demand; for plaintiff's stock interest in respondent was wiped out by the latter's reorganization; plaintiff thus forfeited all future interest in respondent's earnings; and plaintiff's demand here alleged was but "a circuitous way of obtaining something in the nature of equity or value for its ownership [of respondent's stock], rejected in the reorganization plan" (R. 272-4).

The Court of Appeals did not adopt this reasoning; and, as we shall show, it is as untenable as the District Court's first ground of decision.

The Decision of the Court of Appeals.

The Court of Appeals, by a bench consisting of one circuit judge and two district judges, affirmed the decision of the District Court, but on wholly different grounds (R. 2214). One judge dissented.

The majority opinion of the Court of Appeals agreed with our contention that plaintiff and respondent had interlocking managements (R. 2233). But it thought that this duality of control was "not important" (R. 2235). The "mere fact of officers and directors in common", it held, created no fiduciary relation, unless "one corporation dominated the other" (R. 2222); and the Court found the record "barren of evidence" to support our contention that respondent dominated plaintiff (R. 2235). Hence respondent was under no obligation to deal fairly with plaintiff in the tax transaction.

But even if domination and a fiduciary relationship requiring fair dealing be assumed (R. 2223, 2232), the majority of the Court of Appeals held that respondent had not breached its duty to deal fairly with plaintiff (R. 2235). It rejected our contention that it was the purpose of the tax laws to confer a tax benefit on plaintiff (R. 2229-2232); on the contrary, it held that the tax savings here were "an advantage which the tax laws give the subsidiary" (R. 2234). The Court further held that the transaction was fair because it was "open and above board" (R. 2234); because the practice of filing consolidated returns had prevailed in the earlier years of the Western Pacific group (R. 2225, 2233); and because plaintiff had no income of its own against which to offset its tax loss (R. 2232-3). It characterized plaintiff's claim as an attempt to "require tribute" (R. 2235) for its cooperation in filing consolidated returns; and it held that that would have been inequitable because plaintiff and its officers were under a "positive duty" to respondent to file the consolidated returns (R. 2233-5).

Judge Fee dissented (R. 2239), mainly on the grounds that plaintiff's tax credit was its property, which it was under no duty to surrender to respondent; and that the majority's decision was based on facts not found by the District Court and unsupported by the weight of the evidence.

We moved for a rehearing of the case en banc pursuant to 28 U. S. C., § 46(c). The two judges who had rendered the majority opinion (i.e., a circuit judge and a district judge) struck the motion as unauthorized in law (R. 2260); Judge Fee again dissented and suggested a rehearing en banc (R. 2261). Thereafter, upon renewal of the petition, it was denied by the full Court of Appeals sitting en banc (R. 2288) on the ground that the denial by the two judges was authoritative and binding (R. 2296). Denman, Ch. J., dissented (R. 2296, 2313).

Assignment of Errors.

1. The Court of Appeals, without determining or applying any applicable local law, held that the interlock between the managements of plaintiff and respondent (R. 2223) imposed no fiduciary duty on respondent to deal fairly with plaintiff in the tax transaction, unless respondent actually dominated plaintiff's affairs (R. 2222-3). This was error. The managerial interlock alone, regardless of domination, subjected respondent to the fiduciary duty of dealing fairly with the plaintiff; and that is clearly the law of the three jurisdictions (New York, Delaware, California) having contacts with this case.

2. The Court of Appeals held that the record is barren of evidence to support our contention that plaintiff was dominated by respondent (R. 2235). This was error. It was not the Court's function to make such a finding; and its finding was contrary to that of the District Court (R. 264, 272) and to the weight of the evidence.

3. The Court of Appeals held that, even if respondent dominated plaintiff, nevertheless respondent did not breach its duty to deal fairly with plaintiff in the tax transaction (R. 2235). This was error. The tax credit arising from plaintiff's stock loss was plaintiff's property. Respondent utilized plaintiff's tax credit for itself, without allowing plaintiff any share in the resulting benefits. That was not fair dealing by respondent.

4. The Court of Appeals held that respondent did not act unfairly in using plaintiff's tax credit for itself because the tax laws which made respondent's tax savings possible were designed for respondent's rather than plaintiff's benefit (R. 2229-2232, 2234). This was error. By recognizing plaintiff's stock loss as a tax credit, the statute intended to mitigate the loss suffered by plaintiff, not to enrich respondent which had sustained no loss whatever.

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5. The Court of Appeals held that respondent did not act unfairly in using plaintiff's tax credit for itself because the practice of filing consolidated returns had prevailed in previous years and plaintiff had profited therefrom (R. 2225, 2233). This was error. A practice prevailing while plaintiff and respondent were actually affiliated constituted no precedent for a period when the affiliation had ended. Moreover, the Court's finding that in earlier years the companies contributing a tax loss had received no compensation for doing so was beyond the province of the Court to make and was contrary to the evidence.

6. The Court of Appeals held that respondent did not act unfairly in using plaintiff's tax credit for itself because the entire transaction was "open and above board" (R. 2226-7, 2234). This was error. Lack of secrecy does not excuse a breach of duty.

7. The Court of Appeals held that respondent did not act unfairly in using plaintiff's tax credit for itself because plaintiff, having no taxable income of its own, could not use it for itself (R. 2232-3). This was error. Plaintiff's tax credit was its property. It had value precisely because respondent could use it. Moreover, there were possibilities of plaintiff's using the tax credit for itself.

8. The Court of Appeals held that respondent did not act unfairly in using plaintiff's tax credit for itself because plaintiff, as the owner of all of respondent's capital stock, was under an affirmative duty to make its tax credit available to respondent through the mechanics of consolidated returns (R. 2233-5). This was error. Under the tax laws, plaintiff had the right to refuse the filing of consolidated returns. The naked ownership of respondent's stock did not make plaintiff a fiduciary, since the stock did not carry control of respondent, the latter being in the hands of its bankruptcy trustees. Even if plaintiff had been a fiduciary of respondent, it was under no duty to surrender the tax credit, which was plaintiff's property, to respondent.

9. The Court of Appeals made findings of fact where the District Court had made none or had made contrary findings. This was error. The Court of Appeals exceeded its functions; its findings were contrary to the evidence.

10. The Court of Appeals, sitting en banc, held that it had neither power nor duty to consider the application for rehearing on its merits. This was error. The statute, 28 U. S. C., § 46(c), entrusts "a majority of the circuit judges of the circuit" with the decision whether or not a hearing or rehearing en banc shall be ordered. The Court below should not have entrusted this decision to one circuit judge and one district judge and should not have held itself bound by their determination.

Summary of Argument.

We propose to show:

1. Respondent was under the fiduciary duty to deal fairly with plaintiff because of the duality of their managements (Point I, *infra*).

We shall show under this pointhead that, contrary to the decision below, the interlock between plaintiff's and respondent's managements was enough to subject respondent to the fiduciary duty of dealing fairly with plaintiff in the tax transaction. That duty did not depend upon a finding that respondent actually dominated plaintiff; but if domination be deemed essential, it was found as a fact by the District Court and is amply supported by the evidence. Nor was respondent's duty to deal fairly any less stringent because, as the Court below thought, plaintiff had created the managerial interlock, or because respondent had acted openly and without secrecy, or because the dual officers were not actuated by evil motives. The fiduciary duty to deal fairly applies to tax transactions no less than to transactions of a more common or stereotyped nature.

2. Respondent breached its fiduciary duty to deal fairly with plaintiff by taking all, and allowing plaintiff none of the tax benefits produced by the use of plaintiff's tax credit (Point II, *infra*).

We shall show under this pointhead that the transaction between plaintiff and respondent bore none of the earmarks of an arm's length bargain, and hence was unfair to plaintiff. Respondent should have allowed plaintiff all or at least a substantial share of its tax savings. The tax laws permitted the use of plaintiff's stock loss as a tax credit in consolidated returns in order for plaintiff, the parent, to obtain mitigation of the economic impact of its loss, not to confer a benefit upon the prosperous respondent; allowing respondent to retain all of the tax savings produced by plaintiff's tax credit is therefore a perversion of the purpose of the tax laws. Moreover, plaintiff's tax credit was a valuable asset; it was plaintiff's property; plaintiff might have used it for its own benefit; respondent's use of that property for itself without letting plaintiff share in the resulting benefits was unfair.

We shall further show that the fairness of the transaction cannot be sustained on the ground advanced by the Court below that plaintiff owed respondent a "positive duty" to file consolidated returns. Plaintiff was under no such duty; it was not a fiduciary of respondent merely because of its stock ownership, absent control or domination; and if plaintiff be a fiduciary of respondent, it was nevertheless under no obligation to surrender its own property to respondent. We shall also show that the so-called practice of the Western Pacific group of filing consolidated returns in earlier years, when the members of the group were affiliated, created no precedent for what should have been done during a later period in which the economic unity between plaintiff and respondent was at an end; in fact, there was no practice at all relevant to the issue herein.

Fairness, we contend and shall show, required respondent, at the time of the consolidated returns, to agree with plaintiff that the latter was to receive all or an appropriate share of the benefits to be produced by the use of its tax credit. Such an agreement would have been both legal and well supported by precedent. Since plaintiff's dual management, with its allegiance riveted on respondent, failed to secure such an agreement as part of the tax transaction, this Court may do equity and allow plaintiff to recover what was its due in the first place.

3. The Court of Appeals made numerous findings of fact where the District Court had made none or had made contrary findings (Point III, *infra*).

We shall show under this pointhead that the Court of Appeals found numerous facts, important to its conclusions, without any basis in the findings of the District Court and, indeed, contrary to the evidence. This procedure ran counter to the mandate of Rule 52 F.R.C.P.

4. The grounds upon which the District Court dismissed the action were erroneous (Point IV, infra).

We shall show under this pointhead that neither of the two grounds advanced by the District Court justified a dismissal of the action. The District Court thought that plaintiff cannot recover because the tax savings were contrary to law, and equity should not lend its hand in providing for the distribution of illegal gains. But the filing of the consolidated returns was proper vis-a-vis the Government; and the Government settled the tax controversy by a compromise which cannot be collaterally reviewed in this action.

The District Court also thought that a recovery by plaintiff would allow it to share in respondent's income, contrary to respondent's reorganization plan. But that reorganization plan merely eliminated plaintiff's stock-

holdings in respondent; it gave respondent no right to use plaintiff's tax credit. Hence if respondent used plaintiff's tax credit for itself, it must share the resulting benefits with plaintiff and cannot find shelter behind its reorganization plan.

POINT I

Respondent was under the fiduciary duty to deal fairly with plaintiff because of the duality of their managements.

The parties, engaging in the tax transactions we have described, did not deal at arm's length. That was prevented by the duality of their personnel. We contend that, acting in this position, respondent was required by law to treat plaintiff with the highest degree of fairness; that respondent's duties to plaintiff were those of a fiduciary to his *cestui;* and that the dealings between the parties are subject to close and jealous judicial scrutiny.

Under this pointhead we shall demonstrate the existence and scope of respondent's duties; under the next, their violation by respondent.

1. The interlock between the managements of plaintiff and respondent imposed upon respondent a fiduciary duty of dealing fairly with plaintiff in their tax transaction (the "duality rule"); the duty existed regardless of actual domination of plaintiff by respondent.

(a) Throughout the critical period during which the consolidated returns and the refund claim were filed (July 15, 1944 to June 15, 1945), the management of plaintiff was shot through with divided allegiance to respondent. The rule is deeply imbedded in our law that the existence of interlocking managements between two corporations will create a fiduciary relation in dealings between them.

Geddes v. *Anaconda Copper Mining Co.*, 254 U. S. 590, 599 (1921), contains the classical and most frequently cited formulation of the doctrine:

> "The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation; and where the fairness of such transactions is challenged, the burden is upon those who would maintain them to show their entire fairness; * * * This court has been consistently emphatic in the application of this rule, which, it has declared, is founded in soundest morality and, we now add, in the soundest business policy. Twin-Lick Oil Co. v. Marbury, 91 U. S. 587, 588; Thomas v. Brownville, Ft. K. & P. R. Co., 109 U. S. 522; Wardwell v. Union P. R. Co., 103 U. S. 651, 658; Corsicana Nat. Bank v. Johnson, 251 U. S. 68."

And similarly in *Natural Gas Pipeline Co. v. Slattery*, 302 U. S. 300, 308 (1937):

> "Common management of corporations through officers or directors * * * gives such indication of unified control as to call for close scrutiny of a contract between them whenever the reasonableness of its terms is the subject of inquiry."

The rule is of universal application. It has been recognized by the Court below, *Geddes* v. *Anaconda Copper Mining Co.*, 245 Fed. 225, 235-6 (C. C. A. 9, 1917), rev'd on other grounds 254 U. S. 590, in holding

> "that upon principle contracts between corporations having a common director should be regarded very much as are contracts between individual directors and their corporations, and that while such contracts are not prohibited, and are not prima facie void or fraudulent, they are voidable, and that the burden rests upon those who seek to sustain them to show clearly and satisfactorily that they are entirely fair and free from wrong."

The law is the same in Delaware, where plaintiff is organized:

Keenan v. *Eshleman*, 23 Del. Ch. 234, 243-4, 2 Atl. 2d 904 (S. Ct., 1938);

Kennedy v. *Emerald Coal & Coke Co.*; 42 Atl. 2d 398, 402 (S. Ct., Del., 1944);

in California, where respondent is incorporated;

Goodell v. *Verdugo Cañon Water Co.*, 138 Cal. 308, 71 Pac. 354 (1903);

Sausalito Bay Land Co. v. *Sausalito Imp. Co.*, 166 Cal. 302, 306, 136 Pac. 57 (1913);

Title Ins. & Tr. Co. v. *California Development Co.*, 171 Cal. 173, 205-6, 152 Pac. 542 (1915);

in New York, where plaintiff's dual officers functioned and the tax returns were filed;

Chelrob v. *Barrett*, 293 N. Y. 442, 460-2, 57 N. E. 2d 825 (1944);

Globe Woolen Co. v. *Utica G. & E. Co.*, 224 N. Y. 483, 489-90, 121 N. E. 378 (1918, Cardozo, J.);

Marian v. *Mariani*, 276 App. Div. 205, 93 N. Y. S. 2d 370 (1st Dept., 1949);

and in other jurisdictions throughout the land;

Mayflower Hotel Stockholders Protective Committee v. *Mayflower Hotel Corp.*, 173 F. 2d 416, 418-423 (App. D. C., 1949, with numerous references).

The rule rests on "the ancient precept against serving two masters", *Pepper* v. *Litton*, 308 U. S. 295, 311 (1939), a principle as old as Holy Writ, "infallible and hallowed", *Alexander* v. *Theleman*, 69 F. 2d 610, 613 (C. C. A. 10, 1934); *San Diego* v. *San Diego & L. A. R. Co.*, 44 Cal. 106, 113 (1872).

Just as there is danger that a director, in dealing with his corporation, will favor his personal interests, so in transactions between interlocking corporations "the danger to be avoided is that a director or group of directors, common to two corporations, may, for reasons of self-interest, favor one of the entities in its dealings with the other"; *Mayflower Hotel* case, *supra*, 173 F. 2d, at 420. Hence courts impose "the most careful scrutiny of transactions between the corporations represented by common directors, to the end that in the absence of arm's length bargaining, the scales may not, even through mistake or inadvertence, be unfairly tipped to one side or the other"; *Chelrob* v. *Barrett, supra*, 293 N. Y., at 461.

Hence we contend that the mere fact of the duality of the parties' personnel subjected respondent, in its dealings with plaintiff, to the strict duty to treat plaintiff with the highest degree of fairness and loyalty.

(b) Although the Court below conceded "There obviously existed an interlocking management" (R. 2223), it nonetheless rejected the duality rule: "The mere fact of officers and directors in common does not create such a fiduciary relationship" (R. 2222). Duality, the Court thought, merely invites an inquiry "to ascertain if domination exists" (R. 2222); and only if domination is found, will unfairness or overreaching raise a "presumption of constructive fraud" (R. 2222-3).

The Court below did not cite any authorities for its rule thus formulated; and we believe there are none.

To begin with, the scope of the duality rule is clearly a question of state law. Contrary to the mandate of *Klaxon Co.* v. *Stentor El. Mfg. Corp.*, 313 U. S. 487, 496 (1941), the Court below did not determine which state's law was to govern pursuant to the conflict of laws principles of California.

But we need not be detained by the conflict of laws problem. The case has contacts with only three jurisdictions: Delaware, where plaintiff is organized, California, where

respondent is organized, and, most important, New York, where plaintiff's dual management was located and where the tax returns were filed. Each of these States, as we have shown, accepts the duality rule as formulated by this Court in the *Geddes* case, *supra* (254 U. S., at 599); each holds that duality alone, regardless of domination, requires that searching scrutiny of inter-corporate transactions which will result in relief unless complete fairness is demonstrated.

Thus the *Chelrob* case, *supra* (293 N. Y. 442), and the *Marian* case, *supra* (276 App. Div. 205), involved the sale of property by one corporation to another. The sales price was found to be less than the value of the property sold. There was no finding that the purchaser dominated the seller; but the corporations had interlocking managements; and that was held enough to permit the seller to recover the difference between the price received and the fair price.

The Court below, we submit, erred therefore in holding that respondent's duty to deal fairly with plaintiff depended on a finding of domination. It further erred, as we now proceed to show, in holding that domination of plaintiff by respondent was not established (R. 2235).

2. The District Court found, contrary to the Court of Appeals, and the evidence demonstrates, that the conduct of plaintiff's tax affairs was dominated by respondent.

The Court of Appeals found the record "barren of evidence to support the contention that Corporation was dominated by the subsidiary" (R. 2235). This finding of the Court of Appeals is contrary to that of the District Court, and contrary to the evidence.

The findings of the District Court are unambiguous:

> "It was there [in the supplementary complaint] further alleged that the defendant through its officers and attorneys had controlled the board of directors of the plaintiff corporation and that by reason of such control plaintiff was caused to file the consolidated re-

turns for the benefit of the defendant. Throughout the proceedings and in the trial, this has been referred to as 'duality of control'" (R. 264).

"* * * there is a preponderance of the evidence in favor of the plaintiff's contention of 'duality of control'" (R. 272).

This finding that respondent "controlled" plaintiff in the tax transaction could be set aside only if it was "clearly erroneous"; Rule 52(a) F. R. C. P. Far from being erroneous, the finding is supported by the overwhelming weight of the evidence. We cite only a few manifestations of respondent's control.

The decision to use plaintiff's stock loss in consolidated returns was made by respondent, not by plaintiff (R. 1448-1450, 1278). Plaintiff's board of directors was never consulted (R. 1018). Plaintiff's president Curry merely "learned" in January, 1944 that plaintiff's stock loss was to be so used (R. 874-6); but nobody bothered to ask him. Even if plaintiff's directors or officers had been asked, such consultation would have been a mere formality; plaintiff could have neither objected nor demanded conditions since it was being kept alive for the very purpose of preserving its tax credit for the benefit of respondent (Int. Ex. 5, R. 705, 2125-7; R. 713).

Respondent argues that Curry, as plaintiff's president, had a volition about signing the returns. But who was Curry to refuse his signature? He was a mere "figurehead", a "signing officer" (R. 651, 646-7, 1450). His livelihood depended on respondent, not plaintiff; for it was respondent, not plaintiff, that paid his salary (R. 645, 1738). Curry had no understanding whatever of taxes (R. 808). Hence, when the returns were placed before him, he merely asked whether they were approved by tax counsel, i.e., Mr. Polk; and when he was told they were, he signed without further ado (R. 664).

Without so much as mentioning any of these facts, the Court below denies domination because the tax returns

were prepared "under the supervision of Corporation's president" (R. 2226)!

As further support of its finding that plaintiff was free of domination, the Court below says that the returns were prepared "under the guidance of the independent tax experts" (R. 2226). Independent indeed! These tax experts were Messrs. Whitman, Ransom, Coulson & Goetz. This law firm was indeed retained as tax experts—by the trustees for *respondent*, Mr. Schumacher and Mr. Ehrman (Pl. Ex. 39-D, R. 546); Curry was just "told" of their retainer (R. 660). This firm was indeed paid for its tax services—by *respondent*, not by plaintiff (R. 548-557; Pl. Ex. 23, R. 1721). So "independent" was that firm that its partner Polk felt his responsibility was due to his one client, the respondent, and not to his other client, the plaintiff (R. 1431).

But, says the Court below, these tax experts had been "employed upon the suggestion of the General Counsel for Corporation" (R. 2226), i.e., Mr. Nicodemus (R. 2225-6). That is a singularly incomplete description of Mr. Nicodemus' functions. The Court omits mentioning that Mr. Nicodemus and his firm (Pierce & Greer) were also the attorneys for *respondent* and for *respondent's* trustees (R. 533-6, 793); that they received their pay from *respondent*, but no pay whatever from plaintiff (R. 534-8, 1723, 1730-1, 1738); and that it was their job to cooperate with counsel for the trustees of *respondent* in protecting the *respondent's* estate in the preparation of the final returns (Pl. Ex. 39-A, R. 543-4).

We submit that the District Court's finding of domination, far from being "clearly erroneous", was clearly right; that the domination of plaintiff by respondent in the conduct of the tax transaction was fully established; and that consequently respondent was subject to all the fiduciary duties which follow from the exercise of domination and control.

Southern Pacific Co. v. *Bogert*, 250 U. S. 483, 492 (1919);

Kavanaugh v. *Kavanaugh Knitting Co.*, 226 N. Y. 185, 194-5, 123 N. E. 148 (1919);

Title Ins. & Tr. Co. v. *California Development Co.*, 171 Cal. 173, 205-6, 152 Pac. 542 (1915).

3. Plaintiff did not create the managerial interlock with respondent; even if it had, respondent's fiduciary duties would have been the same.

The Court of Appeals, conceding that there existed an "interlocking management" between plaintiff and respondent, held: "But this situation was not of the subsidiary's [respondent's] making. On the contrary, it was created by Corporation [plaintiff], whose stockholders elected its Board of Directors, who appointed its officers" (2223). Although the Court does not spell out the consequences flowing from this finding, it may be assumed that it was thought to lessen, if not to eliminate, respondent's fiduciary obligations.

Actually, however, plaintiff had, during the critical period, no say in the selection of respondent's management. During respondent's reorganization, its trustees, directors and officers were appointed by the bankruptcy court. And after respondent emerged from reorganization in December, 1944, its management was selected by its new stockholders, not by plaintiff.

In any event, it is immaterial who created the duality. There is nothing invidious about interlocking managements as such. Indeed, "business convenience many times requires interlocking directorates"; 3 *Fletcher Cyc. Corp.* (Perm. Ed., 1947), § 961, p. 433. But once duality is created —no matter by whom or how innocently—it subjects the entities to fiduciary standards in their dealings with each other; *In re James Estate*, 86 N. Y. S. 2d 78, 84 (Surr. Ct., 1948). Even though a parent corporation, for business con-

venience, has created duality, nevertheless it is held protected from unfair treatment in transactions with its own subsidiary. *Potter* v. *Sanitary Co. of America,* 22 Del. Ch. 110, 194 Atl. 87 (1937); *Banco Kentucky Co.'s Receiver* v. *National Bank of Kentucky's Receiver,* 281 Ky. 784, 798-9, 137 S. W. 2d 357 (1939).

In *Chelrob* v. *Barrett, supra* (293 N. Y. 442), the duality had certainly been created by the corporation which subsequently sought and obtained relief from the action of the dual management. There, as here, the stockholders of the parent (Queens Company) elected its board of directors; those directors elected its officers; and since Queens owned all the voting stock of the subsidiary (Nassau Company), Queens was also responsible for the selection of Nassau's directors and officers. Queens thus had "created" the interlock; nevertheless, in an action by Queens against Nassau, based upon the unfairness of a contract between the two companies, Queens was permitted to recover.

The Court below, we submit, erred in holding that the managerial interlock between plaintiff and respondent had been created by plaintiff (the District Court had made no such finding); and it erred in ascribing any legal significance to the fact thus found by it.

4. The absence of secrecy did not relieve respondent from the duty to deal fairly with plaintiff.

The Court of Appeals held that "the entire transaction was open and above board. Many persons having an interest in Corporation [plaintiff], including stockholders and counsel, were fully aware of the situation. They chose not to act" (R. 2234). The implication seems to be, either that the lack of secrecy relieved respondent from the duty to deal fairly with plaintiff, or that respondent's duty to deal fairly was fulfilled by respondent's acting "openly".

Again the Court does not reveal upon which local law it predicates this holding. Again the holding is contrary to the laws of all the jurisdictions with which this case has contacts.

Just as a larceny is no less a crime because committed in broad daylight, so a fiduciary cannot escape accountability because his breach of duty was open and notorious. Lack of secrecy is no excuse for a breach of duty. "The publicity alone of an illegal and unauthorized act of the directors of a corporation does not make it legal or valid", *Goodell* v. *Verdugo Cañon Water Co., supra* (138 Cal., at 314); *Blum* v. *Fleishhacker*, 21 F. Supp. 527, 533 (D. C., N. D. Cal., 1937), mod. and aff'd 109 F. 2d 543, cert. den. 311 U. S. 665. In *Marian* v. *Mariani, supra* (276 App. Div. 205), the court, speaking of a transaction between interlocking companies, found that "The sale was made openly and in good faith"; nevertheless the inadequacy of the sales price received by one of the corporations was held to justify it in recovering a fair price from the other. Like facts and rulings were involved in *Chelrob* v. *Barrett, supra* (293 N. Y. 442).

We submit that the Court of Appeals erred in ascribing any legal significance to the alleged lack of secrecy in the transaction.

And it was equally error for the Court below to find (without any such finding by the District Court *) that the transaction was known to plaintiff's stockholders and counsel. In fact, plaintiff's largest stockholder (the James Interests) and plaintiff's counsel were just as dual as

* The Court of Appeals (R. 2226) quotes a remark of the District Judge made by him in the course of the trial (R. 970); but such a remark, made before the conclusion of the trial, cannot take the place of a finding. The Court of Appeals (R. 2227, fn. 11) also quotes what it considers an admission by counsel for petitioners; but counsel, faced with a barrage of simultaneous questions from the bench, answered the last and merely admitted—indeed proclaimed—that the consolidated returns were filed so that respondent would not have to pay any income tax (R. 971); he did not admit that the transaction was "open" and known to plaintiff's stockholders.

plaintiff's officers; and we find no evidence in the record that plaintiff's other stockholders were notified or had knowledge of the tax transaction.

5. The alleged good faith of the dual officers did not relieve respondent from the duty to deal fairly with plaintiff.

Respondent has argued that the dual personnel was honest and free from evil motive. But judicial scrutiny of the fairness of a transaction between interlocking corporations will not be forestalled by a showing that the common officers acted honestly and in good faith.

Chelrob v. *Barrett, supra,* 293 N. Y., at 460-2;
Marian v. *Mariani, supra,* 276 App. Div. 205, 93 N. Y. S. 2d 370 (1st Dept., 1949);
Overfield v. *Pennroad Corp.,* 42 F. Supp. 586, 610 (D. C., E. D. Pa., 1941), rev'd on other grounds 146 F. 2d 889;
Blum v. *Fleishhacker,* 21 F. Supp. 527, 533 (D. C., N. D. Cal., 1937), mod. and aff'd 109 F. 2d 543, cert. den. 311 U. S. 665.

In each of these cases the courts paid tribute to the good faith and honesty of the dual actors as well as to their independence and freedom from domination; they simultaneously imposed the fiduciary duty to deal fairly and found its breach.

Indeed, the rule could not be otherwise. Duality works in an insidious fashion. Even if it does not corrupt the honesty of the dual agent, it may insensibly dampen the exertion of his best skill and ingenuity. Thus respondent here asserts that dual tax counsel never had any thought of plaintiff's right to the tax savings (R. 1433, 1473-5). Assuming these protestations, they merely emphasize the deadly effect of divided allegiance. For the evidence shows

that tax counsel had at hand all the information which would lead him to the realization of plaintiff's rights.* His failure to realize them may well have been due to a lack of wholehearted devotion to plaintiff's cause. To say whether it was or not, would involve that "calculus of probabilities [which] is beyond the science of the chancery", *Meinhard* v. *Salmon*, 249 N. Y. 458, 465, 164 N. E. 545 (1928). Hence the rigid rule of prophylaxis which, in the presence of duality, requires absolute fairness, regardless of subjective honesty and good faith.

6. The fiduciary rule is applicable to tax transactions between fiduciary and *cestui*.

Fiduciaries who mishandle a company's tax affairs or derive private tax advantages from their management of the company's tax business, are subject to the same accountability as in other transactions with their *cestuis*.

Shreveport Bank cases;†

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* As we shall later show, the problem of an inter-company adjustment of tax savings was not uncommon. It arose, just during the critical period, under the S.E.C.'s Rule U-45(b)(6) 17 C.F.R. (1949), § 250.45(b)(6), and was treated in several S.E.C. decisions. In 1943, Polk was familiar with Rule U-45(b)(6) and refered to it in giving advice concerning the tax allocation of the Western Pacific group (R. 1466-7). Copies of the S.E.C. decisions, discussed below, were received by Polk's firm at the time they were released between June, 1943 and January, 1945 (R. 1467-8).

† *Leslie* v. *Commercial Nat. Bank in Shreveport*, 28 F. Supp. 927, 933 (D. C., W. D. La., 1939);
Commercial Nat. Bank in Shreveport v. *Parsons*, 144 F. 2d 231, 236-7 (C. C. A. 5, 1944);
Commercial Nat. Bank in Shreveport v. *Connolly*, 176 F. 2d 1004 (C. A. 5, 1949);
Connolly v. *Commercial Nat. Bank in Shreveport*, 189 F. 2d 608 (C. A. 5, 1951).

Other reported opinions in the *Shreveport* case are listed at 189 F. 2d 609, fn. 1 and 2.

Truncale v. *Universal Pictures Co.*, 76 F. Supp. 465 (D. C., S. D. N. Y., 1948);

Mahler v. *Oishei* (N. Y. Co. Index No. 28485, N. Y. Sup. Ct., Nov. 12, 1947), reviewed 61 Harvard L. Rev. 1058 (1948).

Thus, in the *Shreveport Bank* cases, *supra*, the "old bank" had transferred certain real estate to the "new bank" as collateral security for claims of the new bank, creating a pledgor-pledgee relation. The two banks had interlocking boards. Under the applicable tax laws of Louisiana, a corporation owning real estate was entitled to certain tax deductions. The new bank, as the technical legal owner of the aforesaid real estate, claimed and procured such tax savings. But the courts held that the real estate belonged equitably to the old bank; that the new bank was the fiduciary of the old; and that it must, therefore, account for all private tax savings which it procured in the conduct of its fiduciary activities:

> "The dominant officers of the new bank were the directors of the old, and they were doubly bound to treat the latter fairly." (144 F. 2d, at 236)
>
> "There can be little question but that the relation of the new Bank to the old and the administration of the property and estate intrusted to the former, was one requiring the utmost good faith and constituted it an agent, trustee or fiduciary. * * * It could not profit therefrom in any manner * * *.
>
> " * * * the new Bank * * * should not be allowed to take credit for the taxes paid under the circumstances of this case." (28 F. Supp., at 933)

The Court below would distinguish these cases as involving an actual "trust" relation (R. 2220-1); but there was no "trust" in the technical sense, just a relation of pledgor and pledgee. Certainly the directorial interlock furnished an important foundation for the finding of the fiduciary relationship (144 F. 2d, at 236). And certainly the fiduciary principle was applied to a tax transaction

just as it would have been had the transaction been of a more common or stereotyped nature.

In the *Trancale* case, *supra* (76 F. Supp. 465), the directors of a corporation had exercised options to buy the corporation's stock at prices far below its market value. The difference between the market value and the purchase price constituted taxable income to the directors and, at the same time, a tax-deductible expense to the corporation. The directors, in violation of their fiduciary duties, caused the corporation to waive its right to this tax deduction; the corporation's waiver enabled the directors to save substantial amounts of their private taxes. The directors were held accountable to the corporation for their tax savings, although the amount of their savings far exceeded the tax detriment which the corporation had sustained by reason of its waiver.

The present case likewise involves a tax transaction between plaintiff and respondent. In order to achieve the tax saving, plaintiff and respondent had to agree to join in the consolidated returns. Plaintiff which alone could file them elected to do so; respondent gave its consent. By filing the returns, plaintiff made its tax credit arising from its stock loss available to reduce respondent's taxes; plaintiff surrendered thereby, *pro tanto*, its privilege to use its tax credit as a reduction of its own future taxes. Moreover, by filing the consolidated returns, plaintiff subjected itself to joint and several liability for any taxes or tax deficiencies which the Government might assess on respondent's income (Treas. Reg. 104, § 23.15(d)). In short, by joining in consolidated returns, the parties engaged in a transaction which required mutual contributions and affected their mutual rights and relations.

We submit that, in the light of the duality of plaintiff's management and the dominant part which respondent played in the tax transactions, respondent was under the fiduciary obligation to treat plaintiff with the highest degree of fairness. We proceed to show that respondent breached this obligation.

POINT II

Respondent breached its fiduciary duty to deal fairly with plaintiff by taking all, and allowing plaintiff none of the tax benefits produced by the use of plaintiff's tax credit.

The requirements of "fairness", however general the connotations of that term may be, are well understood. "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain", *Pepper* v. *Litton, supra*, 308 U. S., at 306-7. Or, in the words of Judge Learned Hand, the test is "whether the proposition submitted would have commended itself to an independent corporation", *Ewen* v. *Peoria & E. R. Co.*, 78 F. Supp. 312, 316 (D. C., S. D. N. Y., 1948), cert. den. 336 U. S. 919.

We are thus brought to the question whether the tax transaction between these parties carried "the earmarks of an arm's length bargain". The answer is simple. The filing of the consolidated returns here conferred great advantage—a $17,000,000 tax saving—on respondent, the fiduciary. It conferred no advantage on plaintiff, the cestui. The transaction was thus unilaterally advantageous to the fiduciary. No such transaction could possibly have "commended itself to an independent corporation". If respondent wished to have the use of plaintiff's tax credit, fairness required it to allow plaintiff at least a substantial share in the tax savings to be produced by plaintiff's tax credit. An independent management of plaintiff, competent and well advised, would have insisted on an agreement to that effect; and respondent, if it was willing to act fairly, would have given it.

We propose to show under this pointhead:

1. The purpose of the tax laws, in allowing the use of plaintiff's stock loss as a tax credit in consolidated returns, was to benefit plaintiff, not respondent (A, *infra*).

2. Plaintiff's tax credit was a valuable asset which, in fairness, plaintiff could not be expected to surrender to respondent without receiving an adequate share of the resulting tax benefits (B, *infra*).

3. Plaintiff was under no legal duty to surrender its tax credit to respondent through the filing of consolidated returns (C, *infra*).

4. The Western Pacific group's so-called previous practice constituted no precedent for a period when the affiliation between plaintiff and respondent had ended and was, in fact, non-existent (D, *infra*).

5. An agreement between plaintiff and respondent allowing plaintiff at least a substantial share of the tax savings would have been altogether proper, as evidenced by contemporaneous precedents (E, *infra*).

A

The purpose of the tax laws was to benefit plaintiff, not respondent.

The fairness of a transaction allocating tax benefits between two private parties could in considerable measure depend upon the purpose of the tax law which creates the benefit. Thus if the enjoyment of the $17,000,000 tax saving by respondent, and the denial of any share therein to plaintiff, accorded with the purpose and philosophy of the tax law, then there is much to be said for the fairness of the transaction as between the parties. If, however, respondent's enjoyment of the tax saving was a mere wind-

fall to it, made possible by the letter of the tax statute, but unsupported by its underlying purpose, and if plaintiff's enjoyment of those savings would more nearly fulfill the statutory purpose; then an agreement allowing plaintiff all or a substantial share would indeed be fair.

The Court below apparently recognized that much; but it held that the applicable tax laws were intended to give an advantage to respondent rather than to plaintiff (R. 2229-2232, 2234). In this, we submit, the Court of Appeals erred.

1. *The purpose of § 23(g)(4) of the Internal Revenue Code, in recognizing a stock loss as a tax credit, is to confer a tax benefit on the corporation which has suffered the loss.*

Prior to 1938 a loss resulting from the worthlessness of stock held by a taxpayer was fully deductible for tax purposes. In 1938 the Code was amended to make such losses "capital losses", deductible only from capital gains (Revenue Act of 1938, § 23(g), 52 Stat. 461). In 1942, however, § 23(g)(4)* was added to the Code providing that a loss sustained through the worthlessness of the stock of an affiliate constitutes an ordinary loss, unrestrictedly available as a tax deduction from any kind of income (Revenue Act of 1942, § 123, 56 Stat. 820).

Respondent's stock held by plaintiff became worthless in 1943; and under § 23(g)(4), plaintiff could use this stock loss as a tax deduction against any kind of income.

As stated by the District Court (R. 268), the legislative history of § 23(g)(4) throws no light upon its purpose and philosophy. That purpose, however, would seem to be self-evident: The new section was designed to mitigate the economic impact of such a stock loss. Accordingly the authorities, more fully discussed below, recognize that, realistically, the tax saving resulting from a stock loss should be viewed as a partial offset to such loss; *Matter*

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* See Appendix.

of Consolidated Electric & Gas Co., 15 S. E. C. 161, 164 (1943).

Since in this case the loss was sustained by plaintiff, the tax credit arising therefrom was likewise designed for plaintiff, in order to offset its loss.

Plaintiff's management failed to take any step to effectuate this purpose. Its sole interest was to make plaintiff's tax credit available to respondent. This objective was accomplished through the filing of consolidated tax returns, with the result that plaintiff's tax credit was not used to mitigate plaintiff's loss, but to confer upon respondent what the District Court called an "amazing and undeserved" tax benefit (R. 276).

This diversion of the tax credit from plaintiff to respondent was not only contrary to the purpose of §23(g)(4); it was also, as we now proceed to show, contrary to the purpose of consolidated returns.

2. *The purpose of the consolidated return statute, in permitting the losses of one affiliate to be offset against the profits of another affiliate, is to benefit the common owner of the group, i.e., the parent corporation.*

Consolidated tax returns are permitted by §141 of the Internal Revenue Code* and are governed by regulations issued by the Commissioner of Internal Revenue. These returns may be filed by an "affiliated group of corporations" interconnected by at least 95% stock ownership. The privilege of filing consolidated returns is designed for the protection and benefit of the common owner, or parent, of the affiliated group. Without consolidated returns, the investor, that is, the parent company, investing in two subsidiaries, one profitable, and the other a losing proposition, would have to pay a tax on the income from its good investment, without being able to deduct its loss from the bad one. The rationale of consolidated returns

* See Appendix.

> "is the recognition of this common owner's right to set off against his gains in the one [corporation] his losses in the other [corporation] * * * ";
>
> *Duke Power Co. v. Commissioner*, 44 F. 2d 543, 545 (C. C. A. 4, 1930), cert. den. 282 U. S. 903.

The underlying principle has been well stated by the District Court (R. 269):

> "* * * the philosophy of the consolidated return is to disregard the corporate entity and to tax as a single business or economic unit what really is a business unit * * *. It treats an affiliated group of corporations as one business enterprise, the various affiliates being considered as if they were branch offices of the main business establishment. The income from all units is considered as a single income and the losses of all units are treated as a single loss. (Citing authorities)."

An authoritative statement of the purpose of the consolidated returns statute is found in the *Report of the Senate Finance Committee*, 70th Cong., 1st Sess., S. R. 960, p. 14 (1928), from which, because of its importance, we quote at some length:

> "The permission to file consolidated returns by affiliated corporations merely recognizes *the business entity* as distinguished from the legal corporate entity of the business enterprise. Unless the affiliated group as a whole in the conduct of its business enterprise shows net profits, the individuals conducting the business, have realized no gain. The failure to recognize *the entire business enterprise* means drawing technical legal distinctions, as contrasted with the recognition of actual facts. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that *they are in reality one and the same business owned by the same individuals* and operated as a unit. To refuse to recognize this situation and to require for tax purposes the breaking up of *a single business* into its constituent parts is just as unreasonable as to

require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies. It would be just as unreasonable to demand that an individual engaged in two or more businesses treat each business separately for tax purposes.

"Much of the misapprehension about consolidated returns will be removed when it is realized that *it is only when the corporations are really but one corporation that the permission to file consolidated returns is given*, and that no ultimate advantage under the tax laws really results. The present law permits the filing of consolidated returns only where one corporation owns at least 95 per cent of the stock of the other corporation or if at least 95 per cent of the stock of both corporations is owned by the same interest. *The provision embodies the business man's conception of a practical state of facts.*" (Italics added.)

Accord:

Handy & Harman v. *Burnet*, 284 U. S. 136, 140 (1931);

Atlantic City Electric Co. v. *Commissioner*, 288 U. S. 152, 154 (1933);

Alameda Investment Co. v. *McLaughlin*, 28 F. 2d 81, 82 (D. C., N. D. Cal., 1928), aff'd 33 F. 2d 120 (C. C. A. 9, 1929).

Consolidated returns are thus permitted for the benefit of the "common owner" of the affiliated enterprise, that is, the parent corporation and its stockholders. They are not permitted for the benefit of the subsidiaries. If a subsidiary operates profitably it has no ground, in its own person, to seek a reduction of its taxes, even though its parent, or another subsidiary of the parent, has sustained a loss; for such loss cannot affect the financial position of the profitable subsidiary. But otherwise the common parent; in an economic sense, the profits of each member of the group are the profits of the parent, and the losses of each

member of the group are the losses of the parent; the right to offset such losses and profits against each other is therefore the parent's right, created in the interest and for the benefit of the parent. As stated in the *Alameda* case, *supra* (28 F. 2d, at 82), "The benefit of the statute extends to him on whom is the hazard of the several enterprises", that is, the parent.

It is true that consolidated returns may also redound to the advantage of the subsidiary. Thus where a losing parent files a consolidated return for itself and a profitable subsidiary, the latter's taxes may be reduced. But this tax advantage is not allowed for the subsidiary's sake. It is allowed for the parent's sake which, normally, gets the full benefit of the subsidiary's tax savings by the automatic operation of economic factors—either through the increased value of the parent's stock in the subsidiary or through the declaration of dividends.

It follows, we submit, that plaintiff, as the parent, rather than respondent, as the subsidiary, was the intended beneficiary of the consolidated returns statute.

3. *The Court below erred in holding that the tax laws were not designed for plaintiff's benefit.*

The Court of Appeals rejected our analysis of the purpose of the tax laws (R. 2229-2232). It held that the tax saving here accomplished was "an advantage which the tax laws give the subsidiary" (2234). In reaching this conclusion, the Court below failed to discuss or even to mention any of the legislative materials and other authorities we have cited. It rested its conclusion on a fragmentary analysis of two provisions of the tax law: The provision giving the subsidiary the right to refuse to join in consolidated returns (R. 2230); and the provisions permitting consolidated returns for a period of affiliation less than the taxable year, even though such affiliation had ceased at the time of filing such returns (R. 2230-1).

Neither of these provisions justifies the Court's conclusions therefrom.

(a) *In requiring the subsidiary's consent to the filing of consolidated returns, the tax laws do not indicate a purpose of conferring a tax benefit on the subsidiary.*

The right of the parent, which alone can file consolidated returns, to refuse to do so is not comparable to the right of the subsidiary to refuse to do so. Giving this right to the parent was in furtherance of the purpose and intent that the parent would and should enjoy the benefits. Congress viewed the parent and its stockholders as the owners of one business consisting of a group of affiliates (*supra*, pp. 52-53). The law therefore gives the parent the *sole* right to file consolidated returns for the group (Treas. Reg. 104, § 23.12(a)) on the assumption that, as the common owner, it would and should determine, in its own self-interest, whether or not to file such returns. As stated in *Duke Power Co.* v. *Commissioner* (*supra*):

> "It [Congress] assumed that if there was that degree of affiliation which the law required, there was a dominant control, and it gave to that dominant control the right to make the choice" (44 F. 2d, at 545).

Hence, concluded that Court, if the parent were to "decide that its best interests require filing by it of a separate tax return, no provision of the law denies it this privilege" (p. 545).

The subsidiary's consent was not required for any such reason. Congress obviously did not view the subsidiary as the owner of the group. Therefore, the subsidiary's right to refuse to join is not, like the parent's, given in recognition of its position as the common owner. The principal grounds of requiring the subsidiary's consent were these: (1) To assure uniform action by the entire affiliated group (otherwise the group might play fast and loose by having the parent file a consolidated return and the subsidiary a separate return); and (2) To assure that the subsidiary

is legally bound by the parent's election to file a consolidated return (otherwise the subsidiary might, for instance, deny that it is jointly and severally liable for the taxes payable under the parent's consolidated return, as provided in Treas. Reg. 104, § 23.15(a)).

In the normal situation of economic unity between parent and subsidiary—and that is the situation contemplated by the statute—the subsidiary will be in no position to veto the parent's decision to file a consolidated return, since the "dominant control" of the parent will enable it to guide the subsidiary. The requirement of the subsidiary's consent does not, therefore, as the Court below thought (R. 2230), indicate that consolidated returns are intended for the benefit of the subsidiary.

(b) *The fact that consolidated returns may be filed in certain anomalous situations where the economic unity between parent and subsidiary is severed, does not indicate a statutory purpose to benefit the subsidiary rather than the parent.*

The Court of Appeals recognized that, "in the usual case", an affiliated group of corporations entitled to file consolidated returns is an economic unit so that "the tax saving which a subsidiary effects will inure to the parent by way of increasing the value of its stock or by way of dividends" (R. 2230). But, says the Court of Appeals, there are other situations in which consolidated returns may be filed although there is no "economic unity" between parent and subsidiary. Thus, if the affiliation between parent and subsidiary has ended, the parent may nevertheless file a consolidated return for the affiliated period; if such a return results in a tax saving by the subsidiary, there can be no automatic upstream flow of the benefit to the parent. The same is true if the subsidiary is in bankruptcy; if the parent and the trustees of the bankrupt subsidiary join in consolidated returns, the tax savings of the subsidiary will not automatically redound to the benefit of the parent. From these instances, the Court of Appeals

deduces that the tax laws do not "require" economic unity between parent and subsidiary as a precondition of filing consolidated returns and hence that the statutory purpose of permitting consolidated returns is not to confer a benefit upon the parent (R. 2230-1).

The trouble with this argument is that it confuses the *requirements* of the statute with the *purpose* of the statute. We never contended that the consolidated return statute "requires" economic unity; we do contend that it *contemplates* economic unity; the authorities establish this contention (*supra*, pp. 52-53). It is true enough that all that the statute requires is 95% stock ownership; but the statute makes this requirement on the theory that, by and large, corporations interconnected by 95% stock ownership "are in reality one and the same business", "a single business" (*Senate Report, supra*, pp. 52-53). It is true that in a few anomalous situations the requirements of the statute can be fulfilled, although there is no economic unity; but the purpose of the statute nevertheless remains the same, namely, to grant relief to the owners of an economically unified enterprise.

How, then, did it happen that the purpose of the statute is not precisely reflected in its requirements? The answer lies in the history of the consolidated return statute. Originally, consolidated returns were regulated in strict accordance with their underlying purpose; they could be filed only by a group of affiliated corporations actually constituting an economic unit. See *United States* v. *Cleveland P. & E. R. Co.*, 42 F. 2d 413 (C. C. A. 6, 1930), setting forth the early history of consolidated return law. But the statutory definitions of economic unity proved so vague as to be unworkable. In the interest of administrative convenience (see *Report of Senate Finance Committee, supra*, 70th Cong., 1st Sess., S. R. 960, p. 13), the test of affiliation was therefore simplified: The legal ownership by one corporation of at least 95% of the stock of another corporation was made the sole test of "affiliation". But this change of the requirements of the statute did not

indicate a change of its purpose; the purpose remained the same, namely, to give the owners of the affiliated group the privilege of deducting the losses of one affiliate from the profits of another affiliate, just as if the entire affiliated group were a "single enterprise".

It is true that in those situations where the affiliation has ended prior to the actual filing of the consolidated returns, the "economic unity" then no longer exists. But it does not follow, as the Court below held, that in such situation "any benefits to the subsidiary obviously cannot inure to the parent" (R. 2230). Since only the ex-parent can file consolidated returns, its self-interest will determine whether or not it should file such returns for the affiliated period. The ex-subsidiary, in turn, may prevent the filing by refusing its consent to do so; and it will refuse if its self-interest so dictates. In short, the filing or non-filing of such returns and the sharing of the benefits therefrom could well be the subject of negotiation between the ex-parent and the ex-subsidiary and may well result in the sharing by both corporations. Moreover, the parent, in the very act of terminating the affiliation, can assure itself the benefit of the subsequent filing of consolidated returns. Thus, if the parent were selling its 95% stock interest in a subsidiary to a stranger and at the time of the sale knew that the parent's loss would, in a consolidated return, confer a $17,000,000 tax saving on the subsidiary, could it be doubted that this would be reflected in the price of the stock being sold?

By the same token, the purpose of the tax laws could not be automatically effected by the consolidated returns in the case at bar. Although plaintiff was the parent, its normal and automatic benefiting from the tax saving of its subsidiary, the respondent, could not occur; for the stock certificates of respondent, held by plaintiff, were merely pieces of paper representing neither equity nor right to dividends. Hence, the statutory purpose could be effected only in another fashion, namely, by an agreement among the parties allocating the resulting tax savings.

(c) *The Court of Appeals overlooked that tax savings payments are particularly justified in those situations where, because of the economic severance of the affiliates, the purpose of the tax laws is not automatically effectuated.*

The Court of Appeals advanced one further argument: Granting, says the Court, that in the usual case of an economically unified group the tax savings of the subsidiary redound automatically to the parent (by increasing the value of the parent's equity in the subsidiary), it does not follow that the parent "may receive the benefits direct, regardless of the rights of the subsidiary's preferred stockholders, creditors and minority common stockholders" (R. 2230). In other words: The parent, in consolidated returns, deducts its own loss from the earnings of the subsidiary; the subsidiary's taxes are thereby reduced; this benefits the parent by enhancing its equity in the subsidiary; but the parent cannot receive an actual payment from the subsidiary for making its tax credit available to the subsidiary.

We ask, why not? In the S.E.C. cases discussed below (pp. 75-78), the Commission approved just such payments as fair, under appropriate circumstances. This much, however, is true: In the case of an economically unified group there is ordinarily not much justification for these tax savings payments; for the purpose of the tax laws is fully accomplished by enhancing the parent's equity in the subsidiary; and an actual payment by the subsidiary to the parent will not advance that purpose any further.

But the case is different where, as here, the economic unity of the parent and subsidiary is severed. In that event, the filing of consolidated returns and the resulting tax saving of the subsidiary do not automatically benefit the parent; the parent's loss remains unalleviated by any tax advantage; the subsidiary obtains a tax windfall without economic rhyme or reason; and the purpose of the tax laws fails altogether. That purpose can be more nearly achieved only by the subsidiary's paying all or at least a substantial part of its tax savings to the parent.

While, therefore, in an economically unified group there is ordinarily no need and little justification for a tax saving payment, the need and justification of such a payment is strong where, as here, the economic unity is destroyed.

The Court below referred to "the rights of the subsidiary's preferred stockholders, creditors and minority common stockholders" (R. 2230). But the creditors, the preferred and the minority common stockholders of the subsidiary have no better right than the subsidiary itself to demand that the parent make its tax credit available to the subsidiary. Consolidated returns are not permitted for the benefit of any particular subsidiary, nor for the benefit of the creditors, etc., of that subsidiary; they are permitted for the benefit of the common owner of the affiliated group, i.e., the parent company and its stockholders. If parent and subsidiary are economic strangers, and if the creditors of the subsidiary wish the parent to join with the subsidiary in consolidated returns, they have no more rights in the premises than the subsidiary itself. The Court's reference to the rights of the creditors, etc., of the subsidiary poses, therefore, a false issue.

We submit that an independent management of plaintiff, with all these thoughts in mind, before consenting to consolidated returns and to the use of plaintiff's tax credit by respondent, might well have insisted on an agreement with respondent assuring plaintiff at least a fair share in the dollars to be achieved by their joint action, in accordance with the purpose of the tax laws. And respondent's management, if willing to act fairly, would have acceded to such a demand.

But even if the purpose of the tax laws were not indicative of what fair dealing between these parties required, there were other reasons which made it fair for plaintiff to receive at least a substantial share of the tax savings to be produced by the use of its tax credit.

B

Plaintiff's tax credit was a valuable asset which, in fairness, plaintiff could not be expected to surrender to respondent without receiving an adequate share of the resulting tax benefits.

Plaintiff's tax credit was its property. It was a thing of value. An asset which can produce benefits of $17,000,000 would seem to be valuable indeed. Respondent acted unfairly in causing plaintiff to part with this asset and in using it for itself, without allowing plaintiff a share of the resulting benefits.

The Court of Appeals denied that plaintiff's tax credit was a valuable asset. It thought that plaintiff, having no income of its own, could not utilize its tax credit for itself; hence respondent's use of that tax credit would not "sacrifice" any of plaintiff's interests, but would leave plaintiff "in exactly the same position that it was in before"; it was therefore proper for respondent and its officers to cause plaintiff to file consolidated returns which made plaintiff's tax credit available to respondent; and plaintiff could not demand "tribute" for doing so (R. 2232-3).

The premises as well as the conclusion of the Court below are wholly untenable.

(a) The Court of Appeals erred in holding that plaintiff could not use its tax credit for itself. The value of plaintiff's tax credit must be determined as of the time respondent appropriated it, i.e., July 15, 1944 (the date of the 1943 returns). At that time plaintiff had a real possibility of utilizing its tax credit to its own direct benefit. The fact that plaintiff's tax credit could be carried forward as far as 1945 could have been utilized to attract new capital investments in plaintiff; and plaintiff, with the income produced by such new financing, could have enjoyed the benefit of its tax credit. See *Alprosa Watch Corp.* v. *Commissioner*, 11 T. C. 240 (1948), the facts of which are

set forth in the footnote.* Plaintiff's management, devoted solely to the interests of respondent, entertained no such thoughts; but that does not change the fact that plaintiff's tax credit could have been the instrument of breathing new life into plaintiff. It was therefore an asset of real and substantial value; and the contention that its surrender to respondent cost plaintiff nothing is plainly wrong.

(b) By filing consolidated returns, plaintiff subjected itself to joint and several liability for any taxes or tax deficiencies which might be assessed upon respondent's income. Treas. Reg. 104, § 23.15(d). Fairness certainly did not require plaintiff to make itself gratuitously the surety for the tax obligations of respondent.

(c) Even if it be assumed that plaintiff could under no circumstances have used its tax credit for itself, respondent could. The very fact that plaintiff's tax credit was useful to respondent made it a valuable asset of plaintiff.

Suppose that two corporations with interlocking managements own one patent each; the two patents complement each other; neither can be used without the other. Each patent is worthless to its owner except for the value it has because of its usefulness to the other corporation. The common management causes one corporation to license its patent to the other, without any arrangement for royalties or other consideration. Upon a challenge of this transaction by stockholders of the licensor company, the licensee answers that the transaction is fair because the licensor could

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* The taxpayer in the *Alprosa Watch* case was a corporation engaged in the business of manufacturing and selling gloves under the name of "Esspi Glove Corporation". It sustained a substantial loss in its operations. The stockholders of the corporation thereupon sold their stock to a new group. The new stockholders changed the name of the taxpayer to "Alprosa Watch Corporation", moved its business to new quarters and caused the corporation to give up the glove business and to engage in the business of purchasing and selling jewelry. The Tax Court held that the corporation could use the loss sustained in its glove business as a tax credit against the profits made in its jewelry business.

not use its patent for itself and thus, after the transaction, "was in exactly the same position that it was in before". To a court of equity such an argument would, we believe, be nothing short of shocking.

In our case plaintiff and respondent each had an essential ingredient for achieving a tax benefit. Plaintiff had a $75,000,000 loss; respondent had a large taxable income. Both respondent's taxable income and plaintiff's tax credit were necessary elements to achieve the tax saving, just as both patents were necessary to make a useful process. Plaintiff and respondent did join their resources to produce the tax benefit; and the joint effort of the two was indeed successful. But only one, the fiduciary, respondent, retained all the profit while the plaintiff, its cestui, received none.

Can this result possibly be called fair dealing by a fiduciary with its cestui?

Indeed, the recognition of this unfairness is implicit in the opinion below. For the Court below held that "affiliated corporations are usually associated for the very purpose of dealing with each other for profit" (R. 2221). But certainly this purpose of "dealing with each other for profit" must not become a one-way street. The purpose is foiled if one corporation reaps all the profit of the deal and the other none. Such unequal weighting of the scales becomes doubly repugnant to the sense of fairness where it is the dominant corporation which channels all the benefits of the joint transaction to itself and allows none to its ward whose destinies it has undertaken to guide. We submit that, on the very premises proclaimed by the Court below, the unfairness of respondent's dealing with its and plaintiff's tax affairs is palpable and glaring.

The argument of the Court below that plaintiff was, after the transaction, in the same position as before, implies that plaintiff cannot recover because it did not suffer actual injury. The Court does not reveal upon which local law it predicates the necessity of injury. The law, we submit, is well settled that a fiduciary dealing unfairly cannot

2. *Agreements for the allocation of tax savings are well supported by precedent.*

The question whether the tax benefits arising from consolidated returns have been fairly allocated among affiliated companies will rarely reach the cognizance of a court, since ordinarily the affiliation is too close for inter-company controversies. The question has, however, arisen from time to time in the field of public utility holding companies under regulations issued by the Securities and Exchange Commission. Although these regulations are not directly applicable to the present parties, their administration by the S. E. C. discloses the underlying principles of fairness which sanction the present plaintiff's claim.

(a) The S. E. C. regulation most directly pertinent is the Commission's Rule U-45(b)(6), 17 C.F.R. (1949), § 250.45 (b)(6),* applicable to affiliated groups of public utility companies, and specifically regulating inter-company tax adjustments. This rule directs, in effect, that ordinarily the consolidated tax payable by an affiliated utility group shall be allocated among the members of the group in the proportion of their respective net incomes, but that deviations from this formula may be permitted by the Commission. As stated by the Commission, "Rule U-45(b)(6) was designed to effect a fair distribution of taxes based on consolidated returns".† To effectuate this purpose, the Commission has approved deviations from its rule and permitted "tax saving payments", i.e., payments by a profitable affiliate to a losing affiliate for the use of the latter's tax credit. The Commission's rulings and opinions are therefore significant on the issue of fairness herein.

* See Appendix.

† *Matter of Cities Service Company* (S. E. C. Holding Company Act Release No. 5535, January 3, 1945, File No. 70-933); see *infra*, p. 76.

Matter of Consolidated Electric & Gas Co., 15 S. E. C. 161 (1943), involved an affiliated group of utility companies including a parent corporation ("Consolidated") and 44 subsidiaries. Parent and subsidiaries filed consolidated tax returns. The parent had sold the assets of nine of the subsidiaries, sustaining a large loss on its investment therein. This loss could be used as a tax deduction by reason of a 1942 amendment of the Internal Revenue Code —the same amendment which qualified the present plaintiff's stock loss as a tax deduction. If the loss sustained by Consolidated was utilized in the consolidated return, the taxes payable by the affiliated group would be reduced by more than $2,000,000. Most of this tax saving would redound to the benefit of the subsidiaries, only a small fraction to the direct benefit of the parent.

In order to prevent the subsidiaries from receiving this undeserved windfall at the expense of their parent, the group members entered into an agreement under which the subsidiaries were to pay to their parent all of the tax savings resulting from the parent's capital loss. Since this arrangement was intrinsically fair, the Commission approved it:

> "To the extent that tax savings may accrue to the parent in connection with such sales, the result is in effect to reduce the amount of loss accruing to Consolidated by virtue of the transaction." (p. 163)
>
> "Under all the circumstances we believe that it is more realistic to view the tax savings as, in effect, partial offsets to the capital loss otherwise suffered by Consolidated in connection with the sales." (p. 164)

Like considerations should control the case at bar. The present plaintiff, like Consolidated, sustained an extraordinary capital loss giving rise to a tax deduction. The tax deduction here, like that in the *Consolidated* case, was designed as "partial offset to the capital loss". Just as it was fair for Consolidated to collect from its subsidiaries the tax savings which they obtained through Consolidated's

loss,* so it would have been fair for plaintiff to obtain a similar arrangement with respondent.

Indeed, the present case is much stronger than *Consolidated.* The Consolidated group—unlike the Western Pacific group—constituted an economic unit. The tax savings of Consolidated's subsidiaries thus enured automatically to the benefit of the parent; and the Commission noted that Consolidated might have secured most of the tax benefits of its subsidiaries through the payment of dividends (15 S. E. C., at 164). The permission for tax saving payments was thus a matter of expediency rather than necessity. By contrast, the economic unity of the Western Pacific group was destroyed. Plaintiff could derive no automatic benefit from the tax saving of respondent; an agreement for the sharing of the tax savings was thus, not merely a matter of expediency, but imperatively required in the interest of fairness, to effectuate the "more realistic" view of the tax savings as partial offsets to plaintiff's capital loss.

Matter of Cities Service Company (S. E. C. Holding Company Act Release No. 5535, January 3, 1945, File No. 70-988) contains an even broader statement of the applicable policies. Cities Service Co. was the parent of an affiliated utility group filing consolidated tax returns; Refining Corporation was a subsidiary. Under the war emergency, the Refining Corporation had built a refinery at a cost of $77,000,000, borrowed in large part from the Reconstruction Finance Corporation. The refinery was subject to rapid obsolescence. Pursuant to special dispensation, Refining Corporation was permitted to amortize its investment, for tax purposes, over a period of five years; in other words, it had in each year a tax deduction equal to 20% of its $77,000,000 investment. If these tax deductions were utilized in consolidated returns, they would enure to the benefit of other affiliates rather than that of Refining

* The tax savings paid to the parent in *Consolidated* were solely those flowing from the use of Consolidated's stock loss. Other tax savings flowing from the consolidated return remained with the subsidiaries.

Corporation. This would be an undeserved advantage to those affiliates who had not, with borrowed funds, made a large investment threatened with early obsolescence. The affiliates therefore agreed to pay to Refining Corporation their tax savings derived from the latter's amortization tax credits; and the S. E. C. approved. We quote the Commission's conclusions in full:

"Conclusions

"Rule U-45 (b) (6) was designed to effect a fair distribution of taxes based on consolidated returns. In appraising a proposed deviation from our rule we think it should be observed that in the ordinary case the fact that one subsidiary contributes a particular income deduction to a consolidated return does not in itself entitle that subsidiary to the benefits of the reduced taxes resulting from the deduction. Where tax reductions are possible from filing a consolidated return, they ordinarily are due to a number of factors contributed by the various members of the consolidating group, including, among others, earnings, and excess profits tax credits, as well as income deductions.

"On the basis of the estimates of the tax liability for 1944 it appears that Refining Corporation will contribute special deductions but that the other subsidiaries will contribute the income necessary to permit full utilization of the deductions. Thus, while a portion of the tax reductions possible from consolidation could not be realized without the special amortization items, the reduction likewise could not be realized in the absence of the income furnished by the other companies.

"Obviously it is difficult to determine the precise weight to be given to these various factors and in this case the problem is made more difficult since we have available the results of only five months' operation of the refinery.

"However, the impact of our rule in this instance and the circumstances surrounding the construction of the refinery as recited above persuade us that we should grant the exception requested if the effect in subsequent years will not cause undue detriment to the other subsidiaries of Cities. We shall therefore permit the

escape an accounting on the ground that the *cestui* suffered no detriment.

In *Young* v. *Higbee Co.*, 324 U. S. 204 (1945), a preferred stockholder of a bankrupt corporation, acting as representative of his class, demanded that the claims of certain creditors be subordinated. The District Court rejected the demand. The stockholder appealed; but while the appeal was pending, he sold his stock, and with it the appeal, to his adversaries. He was held accountable for the moneys received although there was no proof that, but for his surrender, the claim would have prevailed. Detriment to the *cestui* (the preferred stockholders as a class) was thus not held to be a prerequisite for recovery from the unfaithful fiduciary. The rule of this case has been followed in New York and in other jurisdictions; *Clarke* v. *Greenberg*, 296 N. Y. 146, 71 N. E. 2d 443 (1947); *Certain-Teed Products Corp.* v. *Topping*, 171 F. 2d 241 (C. A. 2, 1948).

A similar result was reached in the *Shreveport Bank* cases (*supra*, pp. 45-46), where the fiduciary (the new bank) used for itself a tax credit belonging to the *cestui* (the old bank); although the *cestui* could not have utilized the tax credit, it was permitted to recover the tax savings of the fiduciary ("regardless of whether the principal had suffered injury or not", 28 F. Supp. at 933; 144 F. 2d, at 237). And likewise in *Fleishhacker* v. *Blum*, 109 F. 2d 543, 546 (C. C. A. 9, 1940), cert. den. 311 U. S. 665, a bank officer was held accountable for the breach of his fiduciary duty, "even though the bank has suffered no damage". Accord: *Restatement, Restitution* (1937), § 1, Comment (e), pp. 14-15; § 197, Comment (c), pp. 809-810.

Let us compare our case with a more usual commercial analogy: Suppose that a fiduciary manages two businesses, one belonging to himself, the other to his *cestui*. By combining the purchasing power of the two, he buys merchandise at prices cheaper than each business would have had to pay separately. However, the entire amount of the reduced price is kept by the fiduciary; the *cestui* gets none of the savings. Could it be doubted that the

fiduciary would be held guilty of "overreaching or unfairness"? Would even the "morals of the market place" produce such a result were there strangers dealing at arm's length? Would it be any answer for the fiduciary to say that his *cestui* was undamaged because it was still getting the same old merchandise at the same old price? And would the *cestui's* demand for a fair share of the price saving be condemned as an attempt to "require tribute"?

We submit that in our case, as in the above hypothetical case, any reasonable test of fairness would deny that respondent as the fiduciary can take all and give its *cestui* none of the results of their joint efforts.

C

Plaintiff owed respondent no legal duty to file consolidated returns and thus to make its tax credit available to respondent.

The Court of Appeals held that it would have been improper for plaintiff to "bargain" for a share of respondent's tax savings because plaintiff and its officers were under a "positive duty" to file consolidated returns making plaintiff's tax credit available to respondent (R. 2233-5). Plaintiff, says the Court, "was the sole owner of the subsidiary's capital stock" (R. 2234). Hence plaintiff was "under a duty to deal fairly with the subsidiary". Plaintiff therefore "owed a duty not to require its subsidiary to forego a legitimate tax saving and could not bargain to perform its duty" (R. 2234). Had the positions of the corporations been reversed, i.e., had respondent sustained a loss and plaintiff realized a profit, then respondent and its officers would have been obliged to file consolidated returns to enable plaintiff to make use of the loss (R. 2233).

This holding, we submit, is erroneous for several reasons.

1. *Plaintiff's ownership of respondent's stock did not impose fiduciary duties on plaintiff.*

The Court below thought that plaintiff, "as the sole owner of the subsidiary's capital stock", was respondent's

fiduciary. But the law is well settled that naked stock ownership creates no fiduciary duty unless the parent corporation dominates or controls the subsidiary:

Southern Pacific Co. v. *Bogert*, 250 U. S. 483, 492 (1919);

Blaustein v. *Pan American P. & T. Co.*, 263 App. Div. 97, 119, 31 N. Y. S. 2d 934, 956 (1st Dept., 1941), aff'd 293 N. Y. 281, 56 N. E. 2d 705 (1944);

Allied Chemical & Dye Corp. v. *Steel & Tube Co.*, 14 Del. Ch. 1, 12-13, 120 Atl. 486 (1923);

Title Ins. & T. Co. v. *California Development Co.*, 171 Cal. 173, 205-6, 152 Pac. 542 (1915);

13 *Fletcher, Corporations* (Perm. Ed., 1943), § 5811, pp. 127-8.

Thus this Court held in the *Southern Pacific* case, *supra* (250 U. S., at 492):

> "It is the fact of control * * * that creates the fiduciary obligation."

And in *Blaustein, supra*, the New York state court held (253 App. Div., at 119):

> "Mere ownership of a majority or all the stock of a corporation does not in and of itself spell domination. Stockholders are not *ipso facto* trustees for each other. [Citing authorities.] The fiduciary role is not assumed, and the obligation will not be imposed, until a majority stockholder usurps the functions of the directors in the management and conduct of the business of the corporation to the detriment of the corporation and the minority. [Citing authorities.]"

The Court below (R. 2234) cited *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, 522 (1941); but that case does not stand for any rule different from that of the authorities just cited:

> "But equity will not permit a holding company, *which has dominated and controlled its subsidiaries*, to escape

or reduce its liability to those subsidiaries by reliance upon self-serving contracts which it has imposed on them. A holding company, as well as others *in dominating and controlling positions* (Pepper v. Litton, 308 U. S. 295), has fiduciary duties to security holders of its system which will be strictly enforced."

(312 U. S., at 522; italics ours.)

The *Consolidated Rock Products case*, like our other authorities, thus makes domination and control the decisive pre-condition of a parent company's fiduciary duty to its subsidiary.

The exercise of domination by plaintiff over respondent was plainly impossible. Respondent had been in the hands of its bankruptcy trustees since 1935. The Court of Appeals so held: "After the subsidiary was reorganized it was no longer controlled by Corporation but by the trustees appointed by the bankruptcy court" (R. 2223).

In the absence of domination or control, the mere ownership of respondent's stock did not subject plaintiff to any fiduciary duties.

Of course, once plaintiff and respondent actually entered into a transaction with each other, the managerial interlock imposed upon both the duty to deal fairly with each other. But it certainly does not follow that the managerial interlock (any more than the stock ownership) subjected plaintiff to an obligation to file consolidated returns.

2. *The holding of the Court of Appeals that every affiliated corporation having a deductible loss owes its profitable affiliates a duty to join in consolidated returns has dangerous implications, is contrary to the tax laws and finds no support in fiduciary law.*

The holding of the Court below comes, in effect, to this: If in an affiliated group one member has a profit and the other sustains a loss, then the loss company is obligated, as a matter of law, to join in consolidated returns making its tax credit available to the profit company. That such

was its holding was made quite clear by the Court below; for it held not only that plaintiff, as the owner of respondent's stock, was under a duty to respondent to file consolidated returns; it further held that, if the situation had been reversed, respondent would have been under a similar duty to plaintiff.

The consequences of this holding are far-reaching indeed. Under the tax laws, only the parent can file consolidated returns; the filing of such returns is optional. The Internal Revenue Code, § 141(a), refers to the "*privilege* of making consolidated income and excess-profits-tax returns". The law has heretofore been settled that, if the parent's stockholders "decide that its best interests require filing by it of a separate tax return, no provision of the law denies it this privilege", *Duke Power Co.* v. *Commissioner, supra,* 44 F. 2d, at 545.

All this would have to be changed if the Court below were to be sustained. The parent's "privilege" to file consolidated returns would become a compulsion; the option of the various affiliates to consult their best interest would be abolished; the statutory requirement of their consent would become a mere formality or idle ceremony.

We submit that the tax laws, in creating the consolidated return privilege, did not intend any such result; and it should not be created by judicial fiat.

Nor does the fiduciary duty to deal "fairly", if applicable at all, compel any such result. Despite the rigorous rules of fiduciary dealings, we know of no requirement that the fiduciary must turn its own property over to the cestui for the latter's benefit and advantage. The cestui cannot demand it, and no court would compel the fiduciary to do so, no matter how advantageously the cestui could use this property.

The tax credit herein was plaintiff's property, not respondent's; plaintiff could not be compelled to surrender its property to respondent in consolidated returns. Plain-

tiff was free to use its own property as its best interests dictated. Indeed, the Court below, in a different context, so stated (R. 2230):

> "Any subsidiary in the group, as well as the parent, may prevent the filing of consolidated returns if the filing is detrimental or contrary to the interests of such corporation."

Here, then, the Court of Appeals expressly recognized that the parent, in deciding whether or not to file consolidated returns, may be guided by its own interest rather than by that of its subsidiary. Nevertheless, a few pages later in its opinion, the Court of Appeals stated that plaintiff was obliged to file consolidated returns if that was in the respondent's, the subsidiary's, interest (R. 2234). The two holdings are plainly contradictory; and we submit that the first was right, the second wrong.

Hence, whether or not a member of an affiliated group be deemed a fiduciary of the other members is, we believe, immaterial to the question of whether such member can be required to file consolidated returns. If an affiliated company owns a tax credit, it is its own property; and no law, written or unwritten, compels the loss company to join in consolidated returns and thereby to surrender its tax credit to others.

D

The alleged tax practice of the Western Pacific group in earlier years furnishes no precedent for a period in which the affiliation between plaintiff and respondent had ended.

The Court of Appeals advances another reason for sustaining the fairness of respondent's receiving all the tax savings and plaintiff none. The argument runs (R. 2225, 2233): During the years prior to 1943 plaintiff, respondent and their affiliates had consistently filed consolidated tax returns. The taxes paid by plaintiff pursuant to such

returns were allocated among the various affiliates having taxable income in proportion to the amount of such incomes. Affiliates who contributed a loss and thereby reduced the consolidated tax are said to have received no payment for contributing their loss. Such having been the practice before 1942, the Court says it would have been unfair for plaintiff to demand a change in 1943 and thereafter, when such change would be to plaintiff's advantage.

The argument does not stand analysis.

1. It is factually unsound. During the years from 1918 to 1924, one of the affiliates joining with plaintiff and respondent in consolidated returns did make substantial "tax savings payments" to plaintiff, as is more fully demonstrated in the footnote.*

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* The affiliate was the Utah Fuel Company. The facts appear from a Price, Waterhouse report (Def. Ex. 40, R. 1517, not printed in the record, but filed with the Court below and with this Court). Page references in this footnote refer to said Defendants' Exhibit 40.

In the interest of brevity, we confine ourselves to the taxes for the year 1923, other years being similar. In 1923 the separate income of Utah Fuel Company (including its subsidiaries) was $1,053,957.73 (pp. 6, 13). At the then prevailing 12½% tax rate, the income tax payable by Utah Fuel Company, on a separate basis, would have been $131,744.72.

Utah Fuel Company however joined with plaintiff and the other members of the Western Pacific group in a consolidated tax return. Plaintiff had sustained a substantial loss in 1923 (p. 13). The total consolidated tax amounted therefore to only $71,268.88 (p. 13); and the proportionate share of Utah Fuel Company in the consolidated tax would have been only a fraction of this $71,268.88.

But actually the benefit of this tax reduction was not passed on to Utah Fuel Company. On the contrary, Utah Fuel Company paid the full sum of $131,744.72 (p. 6), i.e., the tax it would have had to pay on a separate basis. It paid

to the Government:	$71,268.88
to plaintiff:	$60,475.84 (p. 6)
Total paid by Utah Fuel Co.:	$131,744.72 (p. 6)

This transaction is thus a clear instance of a "tax savings payment" and refutes the holding of the Court of Appeals that none of the loss companies of the Western Pacific group received payment for the use of its tax credit in consolidated returns.

2. In any case, the tax practice of the Western Pacific group in earlier years is totally irrelevant to the events of 1943 and thereafter. The $593,976.33 tax savings which plaintiff is said to have derived by filing consolidated returns (Def. Ex. 46, R. 1552, 2040), accrued during the period from 1924 to 1935 (R. 2040). During this period, the Western Pacific group was an economic unit; tax savings payments would have been unnecessary and pointless since all tax savings automatically redounded to the benefit of plaintiff, the common parent. Thus, if plaintiff sustained a loss and one of its subsidiaries profited, the tax saving of the subsidiary became automatically the tax saving of the parent, so that the formality of a tax saving payment was superfluous. Conversely, if plaintiff had a profit and one of its subsidiaries a loss, a tax saving payment by the parent to the subsidiary would have been as meaningless as it would be for an individual to shift money from one pocket to another. So long as the Western Pacific group constituted an economic unit, there was no reason or purpose for making tax savings payments.

But the situation was quite different when, on March 15, 1943, the economic unity of plaintiff and respondent was severed. From that time on, the automatic upstream flow of respondent's tax savings was interrupted. The tax savings of respondent were no longer the tax savings of plaintiff. Hence it was at this point, and not before, that an adjustment of tax savings between respondent and plaintiff became important and necessary.

We submit that the alleged absence of tax savings payments during the period before 1943—when such payments would have been unnecessary and meaningless—furnishes no test for the years 1943 and thereafter when the usefulness and significance of such payments first arose.

Nor does it afford any justification for the failure of plaintiff's management to obtain an agreement by respondent assuring plaintiff its fair share of the tax savings. Such an agreement, as we now proceed to show, would have been wholly legal and proper.

E

Agreements for the fair allocation of tax savings among affiliated corporations are permitted and well supported by precedent.

In the Court below respondent argued that an agreement between plaintiff and respondent for the allocation of the tax savings would have been illegal; or that, at least, it would have been contrary to some undefined public policy, allegedly reflected in certain administrative rulings. The opposite is true.

1. *Agreements for the allocation of tax savings are expressly permitted by statute and regulation.*

Under earlier Revenue Acts, the subject of inter-company tax allocations was covered by the statute itself. § 240(a) of the Revenue Act of 1918 provided that a consolidated tax shall be assessed upon the respective affiliated corporations "in such proportions as may be agreed upon among them".* Allocation agreements made under this provision were thus binding not only among the parties, but even on the Commissioner who could collect from each affiliated corporation only such share of the consolidated tax as it had agreed to assume.

Since this statutory scheme made the collection of consolidated taxes unduly difficult, it was abandoned by the 1928 amendment of the Revenue Act which authorized the Commissioner of Internal Revenue to make appropriate regulations governing the subject; Internal Revenue Code,

* The Revenue Act of 1918, § 240(a), 40 Stat. 1082, provided, in pertinent part:

> "In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or in the absence of any such agreement, then on the basis of the net income properly assignable to each. * * *"

§ 141(b). Pursuant to this authorization, the Commissioner promulgated Treas. Reg. 104, § 23.15, which provided:

"(a) Several Liability of Members of Affiliated Group.

"Except as provided in paragraph (b), a common parent corporation and each subsidiary, a member of the affiliated group during any part of a consolidated return period, shall be severally liable for the tax (including any deficiency in respect thereof) computed upon the consolidated net income of the group.

* * * * * *

"(d) Effect of Inter-company Agreements.

"Any agreement entered into by one or more members of the affiliated group with any other members of such group or with any other person shall in no case have the effect of reducing the liability prescribed under this section."

This regulation thus had a threefold effect: Each group member became severally liable to the Government for the entire tax; this liability to the Government could not be impaired by an inter-company agreement; but as between the members of the group the validity of inter-company agreements for the allocation of tax burdens or tax benefits was recognized. Unquestionably, therefore, an agreement between plaintiff and respondent, allowing plaintiff a share in the tax savings of respondent, would, as a matter of tax law, have been wholly legal.*

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* Respondent has argued that such an agreement would amount to an improper "merchandising of tax advantages", condemned by cases such as *Gregory* v. *Helvering*, 293 U. S. 465 (1935), and *Higgins* v. *Smith*, 308 U. S. 473 (1940). But the rule of these cases applies only to schemes designed for the evasion of taxes due the Government. Once a tax saving has been legitimately achieved, the Government is not concerned with agreements for the inter-company allocation of the resulting benefits.

fiduciary duties to plaintiff, occupies no different position. As was held by this Court in *Barney v. Saunders*, 16 How. (57 U. S.) 535, 543 (1853):

> "It is a well-settled principle of equity, that wherever a trustee, or one standing in a fiduciary character, deals with the trust estate for his own personal profit, he shall account to the cestui que trust for all the gain which he has made. * * * They [the fiduciaries] cannot be allowed to aver that the profits made on the trust funds should be put in their own pockets because they were unlawful gains, for fear that the conscience of the cestui que trust should be defiled by a participation in them. To indulge trustees in such an obliquity of conscience, would be holding out immunity from misconduct and an inducement to speculate with the trust funds, and put them in peril."

We submit that the District Court's first ground for dismissing the action cannot stand.

B

Plaintiff's claim is not inconsistent with respondent's reorganization plan.

The District Court's reasoning runs: A "saving" in taxes actually means earnings not paid out to the Government. Plaintiff's claim is therefore a demand for a share of respondent's earnings; and the assertion by plaintiff of such a claim "is a circuitous way of obtaining something in the nature of equity or value for its ownership [of respondent's stock], rejected in the reorganization plan" (R. 272-4).

1. The fallacy of this reasoning lies in the confusion of what plaintiff is entitled to get by virtue of its stock ownership in respondent; and what it is entitled to get by virtue of respondent's use of plaintiff's tax credit.

It is perfectly true that respondent's reorganization plan, giving effect to the "absolute priority rule", *Case v. Los Angeles Lumber Co.*, 308 U. S. 106 (1939), precluded plaintiff from any share in respondent's assets or earnings

based upon plaintiff's ownership of stock in respondent. That stock was wiped out by respondent's reorganization plan; and plaintiff was left, at this point, without right or interest in respondent's assets and earnings.

But after this was done—indeed, because it was done—plaintiff had a tax credit. The tax credit belonged to plaintiff; it did not belong to respondent. Respondent's reorganization plan, and the orders approving and confirming it, may be searched from A to Z; no breath of a suggestion will be found that plaintiff's tax credit must be made available to respondent.*

Plaintiff did make its tax credit available to respondent; defendant caused it to do so. This was a new transaction not contemplated by the reorganization plan. Plaintiff's claim stems from this new transaction; for, as we say, plaintiff was in fairness entitled to the benefits from respondent's use of plaintiff's tax credit. By no stretch of argument may plaintiff's claim be viewed as based on its previous stock ownership in respondent.

Indeed, this is graphically demonstrated by the sequence of events. The consolidated returns and the refund claim were filed between July 15, 1944 and June 15, 1945. Prior to any of these dates—on April 30, 1944—plaintiff had surrendered its stock in respondent to the reorganization committee. Plaintiff was therefore no longer a stockholder of respondent at the time the tax returns and the refund claim were filed. Whatever rights plaintiff has in connection with these events, they cannot stem from its stock ownership in respondent which, at that time, was non-existent. It follows that plaintiff's present claim, based upon the use of its tax credit by respondent, does not contravene the provisions of the reorganization plan eliminating plaintiff's stock interest in respondent.

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* The plan could contain no such suggestion. It was formulated in 1939 and approved in 1940 (R. 259). But the statutory amendment, which made the tax credit possible—Internal Revenue Code, § 23(g)(4)—was not enacted until October 21, 1942 (56 Stat. 820).

2. Respondent has argued *ad misericordiam* that plaintiff's claim would undermine the financial position of respondent. But actually it would leave respondent where the bankruptcy courts intended to place it and where respondent itself and its security holders counted on being placed. When this Court passed on respondent's reorganization plan, the junior interests demanded consideration because of respondent's "unexpectedly large earnings"; *Ecker* v. *Western Pacific R. Corp.*, 318 U. S. 448, at 508 (1943). In answer this Court referred to the "effect of taxation" which was "more likely to affect net earnings" (*ibid.*). Respondent's new capitalization was thus based on the assumption that it would have to pay the full taxes on its income; and of this fact respondent gave warning to the world by setting aside a $10,100,000 tax reserve. Respondent has now succeeded in avoiding these taxes. Its security holders thereby obtained a windfall which this Court never contemplated giving them. But the windfall came from the use of plaintiff's tax credit. To say, under these circumstances, that plaintiff's claim to a fair share in this windfall would deplete the assets of respondent or circumvent its reorganization plan is little less than a parody on the facts.

CONCLUSION

It is respectfully submitted that the judgments of the Court of Appeals and of the District Court should be reversed and that this Court should grant judgment for plaintiff in the amount of respondent's tax savings or, at least, of such part thereof as to this Court may appear fair in the circumstances of this case.

Dated: New York, N. Y., November 22, 1952.

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on the brief.

declaration to become effective, but in order that we may have an opportunity to examine the future effects of the amended contract and take any action which may appear necessary or appropriate following such examination, our order will be subject to the condition that the proposed amendment to the contract regarding allocation of Federal income and excess profits tax liability shall cease to be effective upon order of the Commission after notice and opportunity for hearing.

An appropriate order will issue."

This decision clearly shows that the S. E. C. was concerned with the same problem here presented, namely, "a fair distribution of taxes based on consolidated returns." The problem was further similar to ours in that the five-year amortization of the investment was tantamount to an investment loss spread over five years. The S. E. C. held that the tax credit arising from such a loss is designed to mitigate the loss; hence it found fair an agreement among the affiliates effectuating that purpose by a tax saving payment to the Refining Corporation, particularly since the latter needed that payment to discharge its loan obligation to the Reconstruction Finance Corporation. Nor was the arrangement inconsistent with the underlying purpose of the consolidated return statute to benefit the common parent of the group; for the Cities Service group was an economic unit; hence, whichever affiliate might obtain the tax saving in the first place, it was bound to enure ultimately to the benefit of Cities Service, the common parent; and Cities Service, in its own interest, wished to channel the payment to the Refining Corporation.

In the present case the retention of the tax savings by respondent would defeat not only the purpose of the tax law to alleviate plaintiff's investment loss. It would also defeat the purpose of the consolidated return statute to confer a tax benefit on the parent company. Both purposes would be achieved if plaintiff were permitted a share in respondent's tax savings. We submit that fairness required

respondent to make an agreement with plaintiff allowing plaintiff such a share; and since plaintiff's dual management failed to seek or make it, a court of equity will see that equity be done by awarding judgment to plaintiff for its fair share of the tax savings.

(b) The Court below drew different inferences from the S. E. C. decisions just cited (R. 2231-2). It found in these decisions "a decided viewpoint that the tax savings from consolidated returns shall not be paid over to the parent if this would in any way endanger the position of the creditors of the subsidiary". And it also read those decisions as holding that "a company whose loss was utilized for the benefit of the group does not have a right to compensation from those who benefited" (2231).

There are several difficulties with the conclusions thus reached by the Court below. In the first place, they are based upon an abbreviated excerpt from the S. E. C.'s decision in the *Cities Service* case (R. 2231-2) which does not give the slightest inkling of the Commission's actual holding in that case. The Commission did hold in *Cities Service* that, *"in the ordinary case"*, the contribution of a loss by one subsidiary does not "in itself" entitle that subsidiary to compensation. But the Commission also held that in an extraordinary case a different arrangement would be fair; it held that the facts in *Cities Service* presented such an extraordinary situation; and hence it authorized an agreement by which the subsidiary which had contributed the tax deduction received a share of its affiliates' tax savings thus produced. That was the gist of the S. E. C.'s decision; and it was wholly overlooked by the Court below.

We did and do cite the S. E. C. decisions to demonstrate that agreements between affiliated corporations, allowing the loss company a share of the tax savings produced by its loss, have been made in the past; that such agreements, under appropriate circumstances, are "fair"; and that they have found administrative sanction. Each of the S. E. C. decisions cited by us involved such an agreement; and in

each the agreement was approved by the Commission. The Court below completely overlooked this aspect of the S. E. C. decisions.

We fail to find in the S. E. C. decisions any of the broad rules which the Court below purported to distill from them (R. 2231). But even if those rules were to be accepted, they would not be relevant here. Assume, *arguendo*, the Court's postulate (R. 2231) that a subsidiary's tax savings from consolidated returns must not be paid over to the parent if this would endanger the creditors of the subsidiary. There is nothing in this record to indicate that a recovery by plaintiff herein would endanger the creditors of respondent; on the contrary, respondent has a $10,100,000 reserve available for that very purpose. Or assume, *arguendo*, the Court's postulate (R. 2231) that an affiliate whose loss was utilized for the benefit of the group does not, ipso facto, have a "right" to compensation from those who benefited. The question here is whether it would have been "fair" for plaintiff, under the particular facts of this case, to obtain a share of the tax savings to be produced by the use of plaintiff's tax credit. That is the determinative question here; and the S. E. C. decisions clearly show that, under circumstances much less stringent than those at bar, an agreement of this type may be "fair", as well as legal and proper.

We turn back to the test of a "fair" transaction as one which "would have commended itself to an independent corporation". In the light of our discussions under this pointhead, we submit that plaintiff, had it been an "independent corporation", under a management wholeheartedly devoted to its sole interest, would have found literally nothing to commend to plaintiff this transaction by which plaintiff conferred a $17,000,000 tax benefit on respondent, without itself receiving any benefit whatever. Corporations are not organized to distribute largesse to strangers. An independent management of plaintiff, faced with the propo-

sition of filing consolidated returns, would have considered that plaintiff's tax credit was allowed by law in order to mitigate its ruinous stock loss, not to give a tax windfall to the prosperous respondent; that plaintiff might have opportunities to use the tax credit for its own benefit; that, by joining in consolidated returns, plaintiff would subject itself to liability for any tax deficiencies of respondent; that respondent, economically a total stranger to plaintiff, was anxious to obtain the benefit of plaintiff's tax credit; and that plaintiff was under no obligation to surrender it to respondent.

Under these circumstances, the proposition that plaintiff surrender its tax credit to respondent without assurance of an adequate share in the resulting savings was utterly unfair to plaintiff. As a condition of joining in consolidated returns, plaintiff was in fairness entitled to demand that respondent agree to allow plaintiff all or at least a substantial share of the tax benefits to be produced by the use of plaintiff's tax credit.

Plaintiff's dual management failed to make that demand. But this very duality of personnel now enables this Court to scrutinize the transaction between the parties and to do equity by permitting plaintiff to recover a fair share of the tax benefits which resulted from the use of plaintiff's tax credit.

POINT III

The Court of Appeals erred in making findings of fact where the District Court had made none or had made contrary findings.

1. The Court of Appeals rested its decision upon numerous findings of fact made by it rather than by the District Court. It is our contention that it was beyond the province of the Court of Appeals to do so. We proceed to list some of the findings of the Court of Appeals which we believe to have been improperly made.

(a) The Court of Appeals found the record "barren of evidence" to support our contention that respondent dominated plaintiff in the tax transaction (R. 2235). We have shown (*supra*, pp. 38-40) that this finding is contrary to one made by the District Court and also contrary to the evidence.

(b) The Court of Appeals found that, in each year from 1916 to 1942, the corporations forming the Western Pacific group had filed consolidated returns; and that in none of those years did the companies contributing a loss receive any payment (or "tribute") for the taxes saved by the use of their loss (R. 2225, 2233). The District Court did not so find; * and the record clearly establishes that in several instances an affiliate contributing a loss was indeed paid therefor (*supra*, p. 70, footnote).

(c) The Court of Appeals found that, since plaintiff had no income, "there was no possible way for it to achieve any tax advantage to offset the loss" (R. 2232). The District Court did not so find; and we have shown that plaintiff did have possibilities of using its tax credit for itself (*supra*, pp. 61-62).

(d) The Court of Appeals found that plaintiff's officers, when they filed consolidated returns, "were conforming with the policy and directions of Corporation" (R. 2229). The District Court did not so find; and the record shows, without contradiction, that plaintiff's board of directors was not consulted about the filing of consolidated returns for the critical years (R. 1018). Who then formulated plaintiff's "policy" and "directions" which the Court of Appeals found?

(e) The Court of Appeals found that the interlock between the managements of plaintiff and of respondent had

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* The District Court did find that the consolidated taxes were allocated among the various subsidiary companies having taxable income in proportion to the amount of such taxable income (R. 261). But the District Court did not find that there were no payments to other companies contributing a loss.

been created by plaintiff (R. 2223). The District Court did not so find. The record establishes that respondent's personnel was, during respondent's reorganization, appointed by the bankruptcy court rather than by plaintiff; and after the reorganization, respondent's personnel was appointed by its new stockholders and directors, not by plaintiff. Plaintiff's personnel, in turn, was taken over by respondent's trustees as full-time employees of respondent; and tax counsel, representing both plaintiff and respondent, were retained by respondent's trustees, not by plaintiff.

(f) The Court of Appeals found that "many persons having an interest in Corporation, including stockholders and counsel, were fully aware of the situation" (R. 2234). The District Court did not so find; and we have discovered no evidence in the record that plaintiff's stockholders (other than the James Interests who had cast their lot with respondent) were kept abreast of the "situation".

(g) The Court of Appeals described the firm of Whitman Ransom Coulson & Goetz as "independent tax experts" (R. 2226). The District Court, far from considering this firm as independent, referred to them as "the tax attorneys for defendant" (R. 261, 265); and the uncontradicted evidence shows that the firm was anything but "independent" (*supra*, pp. 17-19, 40).

It is unnecessary to accumulate further instances. Each of the findings of the Court of Appeals which we have listed was important to its decision; each was unsupported by any finding of the District Court; each was contrary to the clear evidence.

2. It was beyond the province of the Court of Appeals to make such findings. Rule 52 F. R. C. P. provides, in pertinent part:

> "Findings by the Court.
>
> "(a) *Effect.* In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its

conclusions of law thereon and direct the entry of the appropriate judgment; * * *. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. * * * If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein. * * *

"(b) *Amendment.* Upon motion of a party made not later than ten days after entry of judgment the court may amend its findings or make additional findings and may amend the judgment accordingly: * * *"

This Rule requires that findings on disputed facts be made by the District Court, not by the Court of Appeals. It has been so construed in numerous cases:

Kupperman v. *M. & J. Becker, Inc.*, 198 F. 2d 765, 770 (C. A. 2, 1952);
Jacuzzi Bros. v. *Berkeley Pump Co.*, 191 F. 2d 632, 638 (C. A. 9, 1951);
McClure v. *O. Henry T. & A. Co.*, 184 F. 2d 636, 639 (C. A. 7, 1950);
Kistler v. *Gingles*, 171 F. 2d 912, 915-6 (C. A. 8, 1949);
Campbell v. *Campbell*, 170 F. 2d 809, 810 (App. D. C., 1948).

Indeed, the holdings of this Court indicate the same rule:

Kelley v. *Everglades Drainage District*, 319 U. S. 415, 421-2 (1943);
Oil Shares, Inc. v. *Commercial Trust Co.*, 304 U. S. 551 (1938).

The Court of Appeals nevertheless held that district court findings "are not a jurisdictional requirement of appeal which this Court may not waive", inasmuch as findings of fact are merely "intended to aid appellate courts by affording them a clear understanding of the basis of

the decision below" (R. 2236). For this proposition, the Court below cited three cases:

Mayo v. *Lakeland Highlands Canning Co.*, 309 U. S. 310 (1940);

Goodacre v. *Panagopoulos*, 110 F. 2d 716 (App. D. C., 1940);

Hurwitz v. *Hurwitz*, 136 F. 2d 796 (App. D. C., 1943).

But these authorities do not sustain the procedure adopted by the Court below. In the *Mayo* case, *supra*, this Court reversed the lower court because of the insufficiency of the findings of the District Court; it pointed out that "fair compliance with Rule 52(a)" was "of the highest importance to a proper review" (309 U. S., at 316); and it remanded with directions that "any action taken by the court shall be upon findings of fact and conclusions founded upon the evidence, in accordance with Rule 52(a) of the Rules of Civil Procedure" (p. 319). These rulings are no authority for the procedure adopted by the Court below.

In the *Goodacre* case, *supra* (110 F. 2d 716), the District Court had failed to make "separate findings" of fact, but had embodied its findings in a memorandum opinion. The Court of Appeals held that it was not required to reverse "for a mere formal failure to comply with the rule" (p. 718). That was a far cry from holding that the Court of Appeals could make new findings where the District Court had made none.

In the *Hurwitz* case, *supra* (136 F. 2d 796), the issues had been submitted to a jury on special interrogatories which the jury answered in favor of the plaintiff. On appeal the defendant argued that the cause was of an equitable nature and that the trial court should have made independent findings. The Court of Appeals agreed, but held that such findings were "not a jurisdictional requirement of appeal which this court may not waive", and that "their purpose is to aid appellate courts in reviewing the decision below". This conclusion was stated with respect to a record which the Court of Appeals found to be clear;

hence, it held itself entitled to waive the defect; and it affirmed the decision of the District Court.

Whether or not the *Hurwitz* decision was correct when it was made in 1943 need not be debated; it certainly has lost its vitality since the 1946 amendment to the Federal Rules of Civil Procedure. The *Committee Note of 1946 to Rule 52(a)* states:

> "Findings of fact aid in the process of judgment and in defining for future cases the precise limitations of the issues and the determination thereon. Thus they not only aid the appellate court on review (*Hurwitz* v. *Hurwitz* (App. D. C., 1943), 136 F. 2d 796) but they are an important factor in the proper application of the doctrines of res judicata and estoppel by judgment."

The *Hurwitz* rule that findings are merely designed to aid the appellate court was thus rejected; and with the elimination of that premise, the conclusion that an appellate court may waive findings must equally fall. The weight to be accorded to the Committee Notes is, of course, well recognized by this Court; *Mississippi Pub. Co.* v. *Murphree*, 326 U. S. 438, 444 (1946).

There are good reasons for entrusting the findings of fact to the District Court alone. The District Court sees and observes the witnesses; the Court of Appeals does not. Errors or inadequacies of findings of the District Court may be corrected upon motion pursuant to Rule 52(b); no such procedural machinery is available in the Court of Appeals. The findings of the District Court are binding as between the parties under the rules of estoppel by judgment; expressions in an opinion of the Court of Appeals have no such effect; 2 *Freeman on Judgments* (5th Ed., 1925), § 718, pp. 1518-9.* We submit, therefore, that the

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* And see *Matter of King*, 183 N. Y. 440, 450 (1906): "* * * what is decided by the court is settled by its order and judgment and not by its opinion." Also *Doyle* v. *Hamilton Fish Co.*, 234 Fed. 47, 50 (C. C. A. 2, 1916), cert. den. 243 U. S. 649: "* * * it is not proper to decide the scope of the judgment by the opinion rendered * * *."

Court of Appeals erred in making its own findings; and the Court compounded the error by making findings which were contrary to those of the District Court and contrary to the evidence.

POINT IV

The grounds upon which the District Court based its decision were erroneous.

The District Court predicated its decision dismissing the action upon two grounds:

1. It thought that respondent's tax savings improperly deprived the Government of taxes due it and that this injustice should not be compounded by distributing respondent's illegal gain to others (A, *infra*); and

2. It conceived plaintiff's claim as an attempt by plaintiff to secure part of respondent's income in contravention of respondent's reorganization plan (B, *infra*).

Neither of these grounds was adopted by the Court of Appeals; neither, we submit, has merit.

A

Plaintiff's alleged inability to recover because of the injustice of respondent's tax savings.

We submit that this ground of the District Court's decision cannot stand, for several reasons.

1. *The Government was not unjustly deprived of taxes.*

The District Court strongly felt that the use of plaintiff's tax credit in the consolidated returns and the 1947 tax settlement unjustly deprived the Government of taxes due to it. It described the result as a "tax escape" (R. 270, 271), which was "bizarre" (R. 265), "erroneous and unjust" (R. 271), "amazing and undeserved" (R. 276). The grounds

which brought the District Court to this conclusion are not too clearly stated; but it may be gathered that the Court objected to the filing of consolidated returns in a situation where the companies filing the return are no longer "a single business or economic unit" (R. 269-270).

In so holding, the District Court fell in the same error as the Court of Appeals, although with a different conclusion: It confused the *purpose* of the consolidated return law with its *requirements*. It is quite true, as we have shown, that the purpose of consolidated returns is to treat an economically unified group of corporations as a single taxpayer. But the method by which the law seeks to achieve this purpose is the requirement of 95% stock ownership. Once that requirement is met, consolidated returns may be filed even though, because of anomalous circumstances, the economic unity does not actually exist. Thus where a subsidiary has been placed in bankruptcy, the economic unity is destroyed; nevertheless the parent's 95% stock ownership will enable it to file consolidated returns if the subsidiary's trustee consents. As was held in just such a case in *George A. Fuller Co. v. Commissioner*, 92 F. 2d 72, 73 (C. C. A. 2, 1937):

> "We are now dealing with the 1932 Act, § 141(d), 26 U. S. C. A. § 141 note, under which affiliation follows merely upon ownership by one or more of the other corporations of at least 95 per centum of the stock of each of the corporations (except the common parent) * * *."

Accord:

Trinity Buildings Corp. v. Commissioner, 40 B. T. A. 1315, 1319 (1939).

We submit, therefore, that the lack of economic unity between plaintiff and respondent did not prevent the filing of the consolidated returns although, in the absence of an appropriate agreement between the parties, the returns failed to achieve the statutory purpose for which they were permitted.

2. *The Government's tax claim, if any, has been validly and properly settled.*

It is not even necessary for this Court, at this late stage, to determine whether the consolidated returns were properly filed; for the question of respondent's tax liability was settled between the Government and the parties. There is no room for a collateral attack upon this settlement in the present litigation.

Confronted with a substantial tax controversy, the Commissioner of Internal Revenue was certainly within his rights in consenting to a settlement. The District Court's suggestion that he "would not hesitate to set aside the tax settlement" if he had the power (R. 270), appears therefore gratuitous.

It is even more so because of the complete absence of any ground to impugn the legality or propriety of the settlement. The District Court did not find that the settlement was reached through fraud or corruption; and there is not a shred of evidence which would support such finding. "The presumption of regularity supports the official acts of public officers and, in the absence of clear evidence to the contrary, courts presume that they have properly discharged their official duties"; *United States v. Chemical Foundation*, 272 U. S. 1, 14-15 (1926). This presumption, totally unrebutted here, is the answer to the District Court's unwarranted attack upon the settlement.

3. *Even if the tax settlement had been a wrong against the Government, it would not defeat plaintiff's rights.*

A hypothetical case will serve to make our point. Suppose that the executor of an estate, by improper means, collects an unjust claim of the estate or evades the payment of estate taxes justly due. Will it be suggested that he may retain the fruits of his illegal acts for himself? We believe that he would be accountable to his beneficiary for all profits derived in the course of his conduct as executor and that he cannot escape accountability by invoking his own wrongdoing. The present respondent, by virtue of its

parent in its name will give waivers, give bonds, and execute closing agreements, offers in compromise, and all other documents, and any waiver or bond so given, or agreement, offer in compromise, or any other document so executed, shall be considered as having also been given or executed by each such corporation. Notwithstanding the provisions of this paragraph, however, any notice of deficiency, in respect of the tax for a consolidated return period, will name each corporation which was a member of the affiliated group during any part of such period, and any assessment (whether of the original tax or of a deficiency) will be made in the name of each such corporation (but a failure to include the name of any such corporation will not affect the validity of the notice of deficiency or the assessment as to the other corporations); any notice and demand for payment will name each corporation which was a member of the affiliated group during any part of such period (but a failure to include the name of any such corporation will not affect the validity of the notice and demand as to the other corporations); and any distraint (or warrant in respect thereof), any levy (or notice in respect thereof), any notice of a lien, or any other proceeding to collect the amount of any assessment, after the assessment has been made, will name the corporation from which such collection is to be made. The provisions of this paragraph shall apply whether or not a consolidated return is made for any subsequent year, and whether or not one or more subsidiaries have become or have ceased to be members of the group at any time. Notwithstanding the provisions of this paragraph, the Commissioner may, if he deems it advisable, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself.

(b) * * *

APPENDIX

Text of Statutes and Regulations cited

APPENDIX

Text of Statutes and Regulations cited

Internal Revenue Code

§ 23. *Deductions from gross income.* In computing net income there shall be allowed as deductions: * * *

(g) Capital losses.

(1) Limitation. Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

(2) Securities becoming worthless: If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this chapter, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

(3) Definition of securities. As used in paragraph (2) of this subsection the term "securities" means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.

(4) Stock in affiliated corporation. For the purposes of paragraph (2) stock in a corporation affiliated with the taxpayer shall not be deemed a capital asset. For the purposes of this paragraph a corporation shall be deemed to be affiliated with the taxpayer only if:

(A) at least 95 per centum of each class of its stock is owned directly by the taxpayer; and

(B) more than 90 per centum of the aggregate of its gross incomes for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the company in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price

of operating assets sold), annuities, or gains from sales or exchanges of stocks and securities; and

(C) the taxpayer is a domestic corporation.

§ 122. *Net operating loss deduction.*

(a) Definition of net operating loss. As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) Amount of carry-back and carry-over.

(1) Net operating loss carry-back. If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d), (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

(2) Net operating loss carry-over. If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such intervening taxable year without regard to such net operating loss and without regard to any net op-

erating loss carry-back. For the purposes of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1941 shall be reduced by the sum of the net income for each of the two preceding taxable years (computed for each such preceding taxable year with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and computed by determining the net operating loss deduction without regard to such net operating loss or to the net operating loss for the succeeding taxable year).

§ 141. *Consolidated returns.*

(a) Privilege to file consolidated income and excess-profits-tax returns. An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making consolidated income and excess-profits-tax returns for the taxable year in lieu of separate returns. The making of consolidated returns shall be upon the condition that the affiliated group shall make both a consolidated income-tax return and a consolidated excess-profits-tax return for the taxable year, and that all corporations which at any time during the taxable year have been members of the affiliated group making a consolidated income-tax return consent to all the consolidated income- and excess-profits-tax regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. The making of a consolidated income-tax return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated returns shall include the income of such corporation for such part of the year as it is a member of the affiliated group. In the case of a corporation which is not a member of the affiliated group after March 31, 1942, of the last taxable year of such group which begins before April 1, 1942, such corporation shall not be considered a member of the affiliated group for consolidated income-tax-return purposes for such

year but shall be considered a member of such group for consolidated excess-profits-tax-return purposes for such year, and the consent required in the case of such corporation shall relate only to the consolidated excess-profits-tax regulations.

(b) Regulations. The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making consolidated income- and excess-profits-tax returns and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income- and excess-profits-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. Such regulations shall prescribe the amount of the net operating loss deduction of each member of the group which is attributable to a deduction allowed for a taxable year beginning in 1941 on account of property considered as destroyed or seized under section 127 (relating to war losses), and the allowance of the amount so prescribed as a deduction in computing the net income of the group shall not be limited by the amount of the net income of such member.

(c) Computation and payment of tax. In any case in which consolidated income-tax and excess-profits-tax returns are made or are required to be made, the taxes shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b) prescribed prior to the last day prescribed by law for the filing of such returns; except that the tax imposed under section 15 or section 204 shall be increased by 2 per centum of the consolidated corporation surtax net income of the affiliated group of includible corporations. Only one specific exemption of $10,000 provided in section 710(b) (1)

shall be allowed for the entire affiliated group of corporations for the purposes of the tax imposed by Subchapter E of Chapter 2.

(d) Definition of "affiliated group". As used in this section, an "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(e) Definition of "includible corporation". As used in this section, the term "includible corporation" means any corporation except—

(1) Corporations exempt under section 101 from the tax imposed by this chapter.

(2) Insurance companies subject to taxation under section 201 or 207.

(3) Foreign corporations.

(4) Corporations entitled to the benefits of section 251, by reason of receiving a large percentage of their income from sources within possessions of the United States.

(5) Corporations organized under the China Trade Act, 1922.

(6) Regulated investment companies subject to tax under Supplement Q.

(7) Any corporation described in section 725(a), or in section 727 (e), (g), or (h) (without regard to the exception in the initial clause of section 727) but not including such a corporation which has made and filed a consent, for the taxable year or any prior taxable year beginning after December 31, 1943, to be treated as an includible corporation. Such consent shall be made and filed at such time and in such manner as may be prescribed by the Commissioner with the approval of the Secretary.

(f). Includible insurance companies. Despite the provisions of paragraph (2) of subsection (e), two or more domestic insurance companies each of which is subject to taxation under the same section of this chapter shall be considered as includible corporations for the purpose of the application of subsection (d) to such insurance companies alone.

(g) Subsidiary formed to comply with foreign law. In the case of a domestic corporation owning or controlling, directly or indirectly, 100 per centum of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this chapter and of Subchapter E of Chapter 2 as a domestic corporation.

(h) Suspension of running of statute of limitations. If a notice under section 272(a) in respect of a deficiency for any taxable year is mailed to a corporation, the suspension of the running of the statute of limitations, provided in section 277, shall apply in the case of corporations with

which such corporation made a consolidated return for such taxable year.

(i) Allocation of income and deductions. For allocation of income and deductions of related trades or businesses, see section 45.

Treasury Regulation 104, 26 C. F. R. (1949), § 23

§ 23.12 *Making consolidated return and filing other forms.*

(a) *Consolidated return made by common parent corporation.* A consolidated return shall be made on Form 1120 by the common parent corporation for the affiliated group. Such return shall be filed at the time and in the office of the collector of the district prescribed for the filing of a separate return by such corporation.

(b) *Authorizations and consents.* (1) Each subsidiary must prepare duplicate originals of Form 1122, consenting to these regulations and authorizing the common parent corporation to make a consolidated return on its behalf for the taxable year and authorizing the common parent (or, in the event of its failure, the Commissioner or the collector) to make a consolidated return on its behalf (as long as it remains a member of the affiliated group), for each year thereafter for which, under § 23.11 (a), the making of a consolidated return is required. One of such forms as prepared by each subsidiary shall be attached to the consolidated return, as a part thereof; and the other shall be filed, at or before the time the consolidated return is filed, in the office of the collector for the district prescribed for the filing of a separate return by such subsidiary. No such consent can be withdrawn or revoked at any time after the consolidated return is filed.

(4) A corporation which consents to be treated as an includible corporation for a taxable year beginning after December 31, 1943, shall be treated as an includible corporation for all subsequent years, regardless of whether the affiliated group of which such corporation is a member during such subsequent years is the same as the affiliated group of which such corporation was a member when such consent was filed. No consent to be treated as an includible corporation under section 141(e)(7) can be withdrawn or revoked at any time after the consolidated return is filed for the first taxable year for which the consent is filed.

(b) * * *

§ 23.15 *Liability for tax.*

(a) *Several liability of members of affiliated group.* Except as provided in paragraph (*b*), the common parent corporation and each subsidiary, a member of the affiliated group during any part of a consolidated return period, shall be severally liable for the tax (including any deficiency in respect thereof) computed upon the consolidated net income of the group.

(b) *Liability of a corporation in bankruptcy or receivership.* If, at the time of filing a consolidated return, one or more, but not all, of the members of the affiliated group are in bankruptcy under the laws of the United States or in receivership in any court of the United States or of any State, Territory, or the District of Columbia, then the liability under paragraph (*a*) of each such member of the group with respect to the period covered by such return shall not exceed such portion of the consolidated tax liability for such period as the several corporations included in the consolidated return may, subject to the approval of the Commissioner, agree upon, or, in the absence of such an agreement, an amount equal to its liability for such year computed as if a separate return had been filed.

(c) * * *

(d) *Effect of intercompany agreements.* Any agreement entered into by one or more members of the affiliated group with any other members of such group or with any other person shall in no case have the effect of reducing the liability prescribed under this section.

(e) * * *

§ 23.16 *Common parent corporation agent for subsidiaries.*

(a) *Scope of agency of common parent corporation.* Except as provided in paragraphs (b) and (c) of this section:

(1) The common parent corporation shall be for all purposes, in respect of the tax for the taxable year for which a consolidated return is made or is required, the sole agent, duly authorized to act in its own name in all matters relating to such tax, for each corporation which during any part of such year was a member of the affiliated group. The corporations, other than the common parent, shall not have authority to act for or to represent themselves in any such matter. For example, all correspondence will be carried on directly with the common parent; notices of deficiencies will be mailed only to the common parent, and the mailing to the common parent shall be considered as a mailing to each such corporation; notice and demand for payment of taxes will be given only to the common parent, and such notice and demand shall be considered as a notice and demand to each such corporation; the common parent will file petitions and conduct proceedings before the Board of Tax Appeals, and any such petition shall be considered as having also been filed by each such corporation; the common parent will file claims for refund or credit; refunds will be made directly to and in the name of the common parent and will discharge any liability of the Government in respect thereof to any such corporation; and the common

Securities and Exchange Commission Rule U-45, 17 C. F. R. (1949), § 250.45

§ 250.45 *Loans, extensions of credit, donations and capital contributions to associate companies.*

(a) *General provision.*—No registered holding company or subsidiary company shall, directly or indirectly, lend or in any manner extend its credit to nor indemnify, nor make any donation or capital contribution to, any company in the same holding company system, except pursuant to a declaration notifying the Commission of the proposed transaction, which has become effective in accordance with the procedure specified in Rule U-23, and pursuant to the order of the Commission with respect to such declaration under the applicable provisions of the Act.

(b) *Exceptions.*—The following transactions shall be exempt from the declaration requirements of this rule:

* * * * * *

(6) A loan or extension of credit or an agreement of indemnity arising out of a consolidated tax return filed by a holding company (or other parent company) and its subsidiaries: *Provided,* That the top company in the group assumes primary responsibility for the payment of any tax liability involved, subject to the right to contribution from the several members of the group in an amount not exceeding as to any company that percentage of the sum of the normal tax, surtax, and excess profits tax on a consolidated basis which the sum of the normal tax, surtax and excess profits tax of such company if paid on a separate return basis is of the aggregate amount of normal, surtax and excess profits taxes of the individual companies based upon separate returns. In each instance the amount of excess profits tax shall be computed less the amount of the post-war refund. In computing each company's tax on a separate return basis, allowance shall be made for

loss carry-over and other adjustments as if the company had always filed its tax return on a separate return basis. The amount of post-war refund bonds which the consolidated group will acquire (under section 780 of the Internal Revenue Code) and the liability therefor shall be allocated to the several members of the group in the ratio that the post-war refund bonds each company would acquire on a separate return basis bears to the sum of the post-war refund bonds which all of the companies would acquire on the basis of separate tax returns.